

**Direct Underwriting of  
Government Bonds  
by the Bank of Japan in the 1930s**

**Toshiki TOMITA**

**Nomura Research Institute**

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Since the late 1990s, a period which was plagued by a prolonged economic recession and continued concerns over deflation, a high level of interest has been shown in Japan's economic policy in the 1930s from the perspective that a remedy to get away from deflation might be found in the practices of Finance Minister Korekiyo Takahashi under which the Showa Depression was overcome. In this regard, by paying attention to the fact that Japanese government bonds were required for risk premiums in the international financial market from the end of the 1990s, this paper indicates that Japanese government bonds in the 1930s served as precedents for these bonds.

Prior to the implementation of the underwriting of government bonds by the Bank of Japan, measures were adopted to increase the liquidity of government bonds owned by financial institutions to reduce and eliminate interest risks. Specific measures include loans at the official discount rate by using government bonds as collateral, a change from market value to book value (issue price) in evaluating government bonds owned, the enforcement of the Capital Flight Prevention Law and control of overseas investment by the Foreign Exchange Control Law.

The underwriting of government bonds by the Bank of Japan started in November 1932. While the selling of government bonds on the market by the Bank of Japan was smoothly implemented at first, changes started to occur in the latter half of 1935. Although a policy to reduce the amount of government bonds issued was announced, this policy that could lead to the reduction of military expenditures invoked a backlash among the military. Immediately after the coup in 1936 known as the February 26 Incident, the official discount rate was lowered, and 3.5-percent interest-bearing government bonds again started to be smoothly absorbed by financial institutions.

With the outbreak of the Sino-Japanese War in July 1937, Japan shifted from its quasi-wartime structure to a wartime structure. Measures to absorb government bonds were strengthened, and the amount of government bonds exceeding the nation's economic scale was "smoothly" absorbed. This means that government bonds were jammed into a Japanese economy that was isolated by controls imposed on the transfer of funds.

Under the controlled domestic government bond market, the interest rate remained stable at a low level until the end of the war, and a huge amount of government bonds was absorbed. However, the interest rate of pound-denominated Japanese government bonds on the London market had already started to increase substantially at the time of the Manchurian Incident after September 1931. This reaction was as if the London market had anticipated Japan's defeat and subsequent inflation.

# I Managed Currency System and Low Interest Rate Policy

This paper provides an overview of the path followed by Japan's overseas securities investments as influenced by an embargo on the export of gold (in September 1917) and the lifting of the gold embargo (in January 1930). It also discusses a re-embargo of the export of gold in December 1931 by Finance Minister Korekiyo Takahashi, the promotion of yen depreciation and a low interest rate policy and their impact. The effect of fiscal expansion has frequently been argued in the past as a measure to overcome the Showa Depression. This paper explains that the abolition of the gold standard and yen depreciation by adopting the low interest rate policy, rather than fiscal expansion, gave impetus to autonomous recovery of the economy.

## 1 Lifting of the Gold Embargo and Overseas Securities Investment

The Seiyukai Party Cabinet headed by Giichi Tanaka collapsed due to confusion of the treatment of the assassination of the Manchurian warlord Zhang Zuolin in June 1928. On July 2, 1929, an Imperial order was given to Osachi Hamaguchi, the president of the Minseito Party, to organize a cabinet.

The Minseito Party had already decided to lift the gold embargo at the beginning of 1929. Because the fall in prices after World War I was narrow as compared to those in major European countries and the United States, the trend of excess imports had continued. This policy was aimed at reducing the level of prices within the country, streamlining industrial activities and strengthening international competitiveness by restoring the gold standard. Preparations for the lifting of the gold embargo were made under the management of Finance Minister Junnosuke Inoue, and included budget austerity and the gradual reduction of public bonds. Neither public bonds nor borrowings were included in the general account in the operating budget for fiscal 1930. This was the first attempt since fiscal 1895.

### (1) Refinancing public bonds in foreign currencies

After the Hamaguchi Cabinet was formed, the yen exchange rate started to gradually increase from the level of 100 yen = 43 dollars to a high of 49 dollars in December 1929. During this period, on October 24, 1929, the US stock market crash, known as Black Thursday, occurred and was followed by a worldwide depression. The recession hindered any increase of exports and cast serious shadows on Japan's economy as well. While major banks suffered from difficulties in managing their funds, investment in foreign bonds was not so active in 1929 as they expected that the yen rate would increase in anticipation of the lifting of the gold

embargo and that the prices of foreign government bonds in Japan would drop.

After the lifting of the gold embargo on January 11, 1930, the tendency of yen appreciation continued. Investors who paid attention to the large differential between internal and foreign interest rates actively invested in foreign bonds. According to *Nomura shoken kabushiki gaisha 40-nen shi* (The 40 Year History of Nomura Securities), Nomura's representative office in New York, which was established in 1928, was very busy in handling purchase orders from the head office that were placed on 100,000-dollar units for 6.5-percent interest-bearing public bonds at the beginning of 1930.<sup>31</sup>

At the election held in February 1930 immediately after the lifting of the gold embargo, the Minseito Party increased its number of seats in the Diet by 100 seats to 273 seats. In contrast, the Seiyukai Party, which opposed the lifting of the gold embargo, lost 63 seats, resulting in 174 seats. The result of this election indicates that many voters supported the Minseito Party headed by Hamaguchi, which called for a policy of budget austerity.

In May 1930, the government implemented the refinancing of the second 4-percent interest-bearing pound-denominated public bonds issued in November 1905 whose maturity was nearing. Smooth implementation of this refinancing also constituted a major factor behind the lifting of the gold embargo. The total amount of the refinancing bonds issued was 264.4 million yen and consisted of dollar-denominated bonds worth 71 million dollars and pound-denominated bonds worth 12.5 million pounds. The issue conditions were 5.5-percent interest bearing, maturity in May 1965 and an issue price of 90 percent of face value. The fixed exchange rate of 1 pound = 4 dollars 86.65 cents was applied to the conversion rate between dollars and pounds for the payment of principal and interest.

While the refinancing of bonds in foreign currencies, which had been a long-pending issue for the Japanese government, could be implemented, a high coupon rate (nominal coupon) of 5.5 percent was required. Because the issue interest rate was 6.2 percent in terms of compound interest, yearly interest payments increased by 5.3 million yen.<sup>12</sup> Because of this, according to *Nihon Ginko hyakunen shi* (the Hundred-Year History of the Bank of Japan), there was criticism that went to the extent of referring to this bond as the "second national disgrace public bond" following the first one called after the Great Kanto Earthquake.<sup>29</sup>

### (2) Collapse of pound-denominated public bonds by the Manchurian Incident

On September 18, 1931, an incident occurred in which tracks of the Japanese-operated South Manchurian Railway were blown up near Liutiao Lake on the outskirts of Mukden. On September 20, the United Kingdom

abolished the gold standard. Overseas investors saw the outbreak of the Manchurian Incident triggered by the Liutiao Lake Incident as signs that Japan would choose to abandon its policy of international cooperation and instead would strengthen its approach to the invasion of China, which led to a large risk premium required of Japanese government bonds on the London capital market.

While the market price of 2.5-percent British consols (the perpetual bond for which interest payments continue with no redemption obligation on the part of the government although there is a possibility of call redemption) had remained at almost the same level, i.e., 57.6 percent of the face value in August, 55.6 percent in September and 55.6 percent in October, the market price of 4-percent interest-bearing Japanese public bonds in pounds on the London capital market dropped sharply from an average of 79.56 percent in August to 78.75 percent of the face value as the high price in September and 60 percent as the low price in September.

Accompanying the abolition of the gold standard by the United Kingdom, yen sharply appreciated from 1 pound = 9.84 yen in August to 1 pound = 7.55 yen in October. As shown in Figure 8, due to the fall of the government bond price in pounds and yen appreciation and pound depreciation, the market price of the 4-percent interest-bearing pound-denominated public bonds worth 100 pounds dropped from 790 yen in July and August to 500 yen in October.

However, the rise of yen to pounds was only temporary. The abolition of the gold standard for pounds had given birth to a projection that a re-embargo of the export of gold for yen would be near. On the exchange market that was stable after the lifting of the gold embargo, yen-selling and dollar-buying trades were active, and investments in foreign bonds also expanded.

The Bank of Japan sold a large amount of dollars at the rate of 100 yen = 49.375 dollars through the Yokohama Shokin (Specie) Bank, and endeavored to protect yen by increasing the official discount rate. The official discount rate was increased from 1 *sen 4 rin* to 1 *sen 6 rin* in terms of a daily interest rate per 100 yen on October 5, 1931, and to 1 *sen 8 rin* on November 5. Furthermore, in order to restrain investment in foreign bonds, the guarantee by the Bank of Japan was removed from Japanese government bonds in foreign currencies. Despite these measures, the outflow of a huge amount of funds overseas continued.

While people had much expectations of the recovery of the economy from the lifting of the gold embargo, the depression was further aggravated. In 1929, wholesale prices were lowered by 2.9 percent. As influenced by the worldwide depression, these prices dropped in 1930 and 1931 by 17.7 percent and 15.4 percent, respectively. The real economic growth rate during this period was confined to around 1 percent. The mili-

tarists opposed the Minseito Party Cabinet's non-expansion policy in Manchuria, and the opposition Seiyukai Party criticized the Cabinet for the depression, saying it stemmed from the lifting of the gold embargo.

Because Kenzo Adachi, the minister of home affairs, attempted to promote a coalition with the Seiyukai Party, the Cabinet headed by Reijiro Wakatsuki faced disharmony, and resigned *en bloc* on December 11, 1931. This ended the fiscal policies adopted by Finance Minister Inoue with a focus on international equilibrium, which were implemented in association with the peaceful foreign policy promoted by Kijuro Shidehara, the minister for foreign affairs.

## 2 Re-embargo on the Export of Gold

On December 12, 1931, an Imperial mandate was issued to Tsuyoshi Inukai, the president of the Seiyukai Party, to form a new Cabinet. On December 13 (Sunday), an embargo of gold exports was decided at a ministerial meeting. From that date, except for the period from July to November 1934 immediately after the collapse of the Makoto Saito Cabinet due to the groundless Teijin incident, Korekiyo Takahashi served as finance minister until he was shot to death by an assassin in the coup in 1936 known as the February 26 Incident. This period is often referred to as Takahashi's expansionary finance period. However, the basis of his policy consisted of the increase of money supply and the implementation of a low interest rate policy through the introduction of a managed currency system and controls on capital outflow.

### (1) Promotion of exports through yen depreciation

In January 1930, under the title of "Ways to Deal with Economic Difficulties," Korekiyo Takahashi noted that "as is generally known, the fact that Japan could free itself from economic difficulties earlier than other countries is largely attributable to rapid increases of exports and the proper supply of money. (Omitted.) The policy of the re-embargo of gold exports was aimed first at giving opportunities for trade exports to advance and second at the same time supplying the appropriate amount of currency within the country to restore the balance between production and consumption, thereby smoothing the linkage and adjustment between production and consumption."<sup>26</sup>

Finance Minister Takahashi suspended the gold standard by re-prohibiting gold exports (December 13, 1931) and halting the conversion of bank notes to gold (December 17), and promoted exports by accepting the decline of the yen rate. He lowered the official discount rate to a daily interest rate per 100 yen of 1 *sen 6 rin* (annual rate of 5.84%) on March 12, 1932, to 1 *sen 4 rin* (5.11%) on June 7 and further to 1 *sen 2 rin* (4.38%) in August. These measures accelerated the

decline of the yen rate. As shown in Figure 1, although parity was 100 yen = 49.845 dollars (1 dollar = about 2 yen) immediately before the re-embargo of the gold export, the low price in December 1932 was 100 yen = 20 dollars (1 dollar = 5 yen). This equals a decline of about 60 percent in one year.

However, criticism was raised that rapid yen depreciation might have an adverse effect on industry, and deep concerns were expressed that an increase in overseas securities investment might shrink the money supply, resulting in an economic slowdown. As a large volume of dollars was already sold through intervention by the Bank of Japan to lift the gold embargo and to maintain the former parity, the gold reserve held by the Bank of Japan had substantially decreased from 1.07 billion yen at the end of 1929 to 470 million yen at the end of 1931. The issue of Bank of Japan notes was restrained, and an excess issue of such notes, on which a high issue tax of 5 percent (the excess issue tax was imposed if notes beyond the issue limit were issued) was imposed, had become a normal condition.

In order to deal with this situation, the Convertible Bank Notes Ordinance was amended for the first time in 33 years since 1899 at the 62nd Imperial Diet session in June 1932. This amendment expanded the guaranteed issue limit from 120 million yen to 1 billion yen at one stroke. (Guaranteed issue means the issue of Bank of Japan notes by using government bonds, etc., rather than specie (gold or foreign currencies that can unquestionably be converted to gold), as the reserve.) The tax rate for an excess issue was also lowered to 3

percent. *Nihon ginko hyakunen shi* (the Hundred-Year History of the Bank of Japan) points out that this was the first step taken by Japan's currency system towards a managed currency system.<sup>29</sup>

**(2) Introduction of the Capital Flight Prevention**

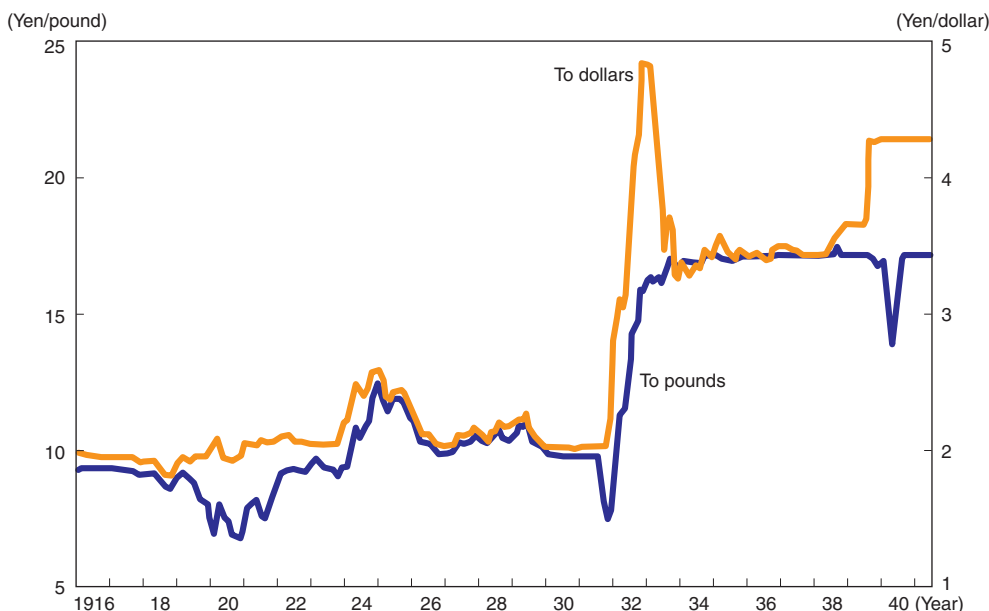
**Law**

In addition, the Capital Flight Prevention Law that limited purchases of foreign currency securities, overseas real estate, etc., was enacted in July 1932 in order to prevent violent fluctuations of foreign exchange rates as disturbed by overseas securities investments and/or to avoid any influence that might hinder the lowering of the domestic interest rate. The background factors behind this enactment included a sharp decline of the prices of Japanese government bonds in foreign currencies on overseas markets, which concurrently entailed progress in yen depreciation. Because of this trend, capital outflow overseas continued, which further accelerated yen depreciation and was partly responsible for the decrease in bank deposits.

*Showa zaisei shi* (Financial History of Showa) explained that “the Seiyukai Party, which had an absolute majority in the Diet, decided on a currency devaluation of 20 percent. This decision had a major impact on overseas markets, and invited fiercely speculative trades among investors in Shanghai and Dalian. In late June, the exchange rate declined sharply from 100 yen = 30 dollars to 26 dollars.”<sup>13</sup>

Korekiyo Takahashi noted that “because we adopted the policy to supply a large volume of money far

**Figure 1. Changes in Rates of Yen to Dollars and to Pounds**



Notes: Japan placed an embargo on gold exports on September 12, 1917, lifted the embargo at the old parity on January 11, 1930, and re-prohibited gold exports on December 13, 1931. The United Kingdom resumed use of the gold standard in May 1925, and suspended the standard in September 1931. The United States placed an embargo on gold exports on September 7, 1917, resumed use of the gold standard on June 21, 1919, and suspended the standard on April 19, 1933. The yen rate was pegged at 1 yen = 1 shilling 2 pence from October 20, 1934, to October 1939. Following October 25, 1939, the yen rate was pegged at 100 yen = 23.4375 dollars. After December 8, 1941, no notifications were provided on market prices of yen because it was considered hostile currency.

Source: Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics 1914-1941*, Federal Reserve System, 1943.

beyond the amount of specie owned within the country, a decline of the yen rate to foreign currencies was a matter of course. Accordingly, if a climate of capital flight is seen and if a low interest rate policy is further promoted, it is unavoidable under economic rules that we face a further accelerated trend towards capital flight. In order to prevent such capital flight, we decided to first take adequate measures for this purpose by establishing the Capital Flight Prevention Law and the Exchange Control Law. Following such measures, we decided to promote a low interest rate policy.”<sup>26</sup>

After the abolition of the gold standard, the official discount rate was lowered twice in March and June 1932. However, from the international perspective, it was still at a high level of 5.11 percent as of June. In the United Kingdom, which suspended the gold standard in September 1931, the official discount rate was reduced from 6 percent to 2 percent in June 1932. The Federal Reserve Bank of New York lowered the official discount rate by 0.5 percent respectively in February and March 1932 to 2.5 percent.

While foreign exchange rates came to a temporary lull immediately after the enactment of the Capital Flight Prevention Law, the decline of the yen rate was accelerated beyond the level of 100 yen = 25 dollars in mid and late August 1932. This trend was largely attributable to the active promotion of a low interest rate policy as represented by an August 16 decision at a ministerial meeting on the lowering of the postal savings interest rate (from 4.2% to 3%) and the third lowering of the official discount rate on the following day (from a daily interest rate per 100 yen of 1 *sen* 4 *rin* to 1 *sen* 2 *rin*).

As its name indicates, the Capital Flight Prevention Law was aimed at preventing the flight of capital, and was not intended to control foreign exchange transactions accompanying exports and imports. Because of this, the anticipation of yen depreciation increased under the background factor of the promotion of a low interest rate policy, and import exchanges sharply increased. It can be assumed that the projection of a weaker yen became a reality through such processes. Actually, the yen's fall was accelerated by going below the level of 100 yen = 25 dollars and further to the level of 100 yen = 20 dollars at the end of November.

### (3) Establishment of the Foreign Exchange Control

#### Law

It is true that the acceleration of the yen's fall brought about the expansion of exports. However, because such acceleration led to excessively expanded exports, it also caused a rise in the prices of imported raw materials as well as an increase in principal and interest payments for debt in foreign currencies. To remedy this situation, studies were made on the stabilization of the yen rate. According to *Showa zaisei shi* (Financial History of Showa), consideration was given to the intro-

duction of the exchange equalization account that had been established in the United Kingdom in April 1932. However, because this account was chiefly intended to control the rise of pounds, it was decided that it could not be applied in Japan where prevention of the yen's further slide was necessary. Instead, studies were made on foreign exchange control and foreign trade control.<sup>13</sup>

In February 1933, the Foreign Exchange Control Law was submitted to the Diet. While replacing the Capital Flight Prevention Law, this law vested extensive control in the government, such as strengthening the control of foreign exchange transactions, establishing the official exchange rate, concentrating foreign exchange transactions in the Bank of Japan, the Yokohama Shokin (Specie) Bank, etc. and making it possible to subject foreign trade to government control.

Kazuo Aoki, then manager of the Treasury Division of the Financial Bureau of the Ministry of Finance, noted that “this law was unprecedented in that it imposed a fine several times the transaction price for any violation. Many subsequent control laws such as the National Mobilization Law followed the precedent set by this law.”<sup>15</sup> However, as pointed out by Masanao Ito, import control was not invoked until January 1937 on the grounds that foreign trade must be based on liberalism to the greatest possible extent.<sup>4</sup>

On March 5, 1933, during the deliberation of the Foreign Exchange Control Law in the Diet, the United States issued an emergency declaration on the closure of banks, and suspended the gold standard by Presidential decree on April 19. This cut the dollar parity by 40.94 percent, and the yen rate against dollars rapidly rose.

To deal with this situation, the government changed the overseas standard indicator of the yen rate from dollars to pounds on March 8, and controlled speculative transactions in accordance with the Foreign Exchange Control Law that was enforced starting in May. Through these measures, the yen rate against pounds was stably maintained at the low level until the beginning of the invasion of Poland by Germany (September 1939). The subsequent yen rate against pounds was pegged at 1 yen = 1 shilling 2 pence from October 20, 1934 (1 shilling = 1/20 pound, 1 penny = 1/240 pound).

These measures that were aimed at the stabilization of the yen rate at the low level were also intended to separate the government bond market from overseas markets in order to easily issue a large volume of government bonds.

### (4) Start of measures to promote the ownership of government bonds

In addition, in preparation for the issue of a large volume of government bonds, an environment was established to absorb such bonds. Specifically, this means efforts to restrain interest risks (government bond price

fluctuation risks) that were generated by the ownership of government bonds by commercial banks. The first step for this purpose was started on April 26, 1932. The high interest rate applied by the Bank of Japan to loans using government bonds as collateral was relaxed. In the past, the official discount rate (commercial bill discount interest rate) plus a daily interest rate per 100 yen of 1 *rin* (annual rate of 0.365%) was applied to loans using government bonds as collateral. However, the application of a high interest rate was abolished for loan periods not exceeding 30 days, and the minimum official discount rate was uniformly and unlimitedly applied regardless of the loan amount.

In July 1932, the Law Concerning the Calculation of Government Bond Prices was promulgated. Notwithstanding the provisions of the Commercial Code that adopt the market value basis in evaluating property, this law required the usage of the standard issue price announced by the finance minister for each issue of government bonds as the book value. This law was established not at the request of financial institutions but under the enthusiastic efforts of Finance Minister Takahashi who tried to let financial institutions have government bonds on a “spontaneous” basis.

In other words, the official market was created for government bonds under circumstances where no official markets were available for other financial products. Each time a new government bond was issued, a standard price was determined. This scheme eliminated the need for banks to enter appraisal loss in an account ledger even if the market price of government bonds declined, and promoted the ownership of government bonds by banks. At the same time, this scheme made it easy to maintain the government bond price.

These measures facilitated the lowering of the interest rate of government bonds.

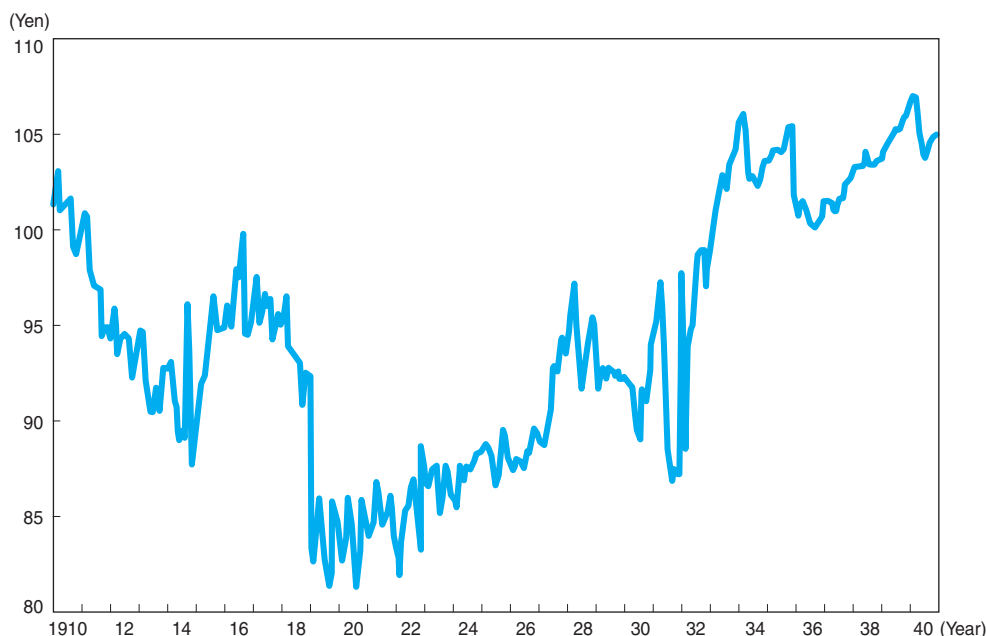
The price of the *Ko* 5-percent interest-bearing public bond that was the representative issue at that time was at a high level of 98.35 yen per face value of 100 yen in July 1931 before the outbreak of the Manchurian Incident. However, as shown in Figure 2, in December 1931 when Takahashi finance began, the price dropped to as low as 86.15 yen as influenced by such factors as capital outflow in anticipation of the re-embargo of gold exports, an increased issue of government bonds and the reduction of the amount transferred to the government bond management fund.

Following this, however, despite price fluctuations and an increased issue of government bonds, the highest price became 99.20 yen in November 1932 through the shift to the managed currency system, the lowering of the official discount rate, control of capital outflow and the introduction of measures to absorb government bonds. Subsequently, as explained in a later section of this paper, direct underwriting of government bonds by the Bank of Japan started on November 25, 1932.

### 3 Details of Takahashi’s Expansionary Finance

As described above, Finance Minister Korekiyo Takahashi controlled capital outflow overseas, increased the money supply and promoted a low interest rate policy. Through these measures, he facilitated a monetary relaxation policy by financially closing the country through exchange control. Regarding the economic policy of Finance Minister Takahashi, Kiyosaku Nishino who was a journalist at that time, noted that

**Figure 2. *Ko* 5-Percent Interest-Bearing Public Bonds (monthly average price on the Tokyo market)**



Source: The Financial Bureau of the Ministry of Finance eds., *Government Debt Statistics Yearbook* for each fiscal year.

“although his policy was criticized as a loose, irresponsible policy by orthodox public finance scholars, Takahashi-san believed that lowering the interest rate would spontaneously improve the public economy. It was Takahashi-san’s economic measures that gave focus to such a point.”<sup>14</sup>

In contrast, Chikara Tsutomu said that “I cannot believe that Takahashi knew the Keynes theory at that time. (Omitted.) However, it can be said that Takahashi’s ability to see the actual status has already reached the level of Keynes.”<sup>7</sup> Shinichi Goto believes that Finance Minister Takahashi converted the policy of austerity finance adopted by Finance Minister Inoue into a policy of expansionary finance, and recovered the economy through such financial initiative.<sup>19</sup>

Today, the evaluation of Finance Minister Takahashi is largely divided with respect to whether he adopted a principle of expansionary finance or one of sound finance. The following discusses details of his policy.

### (1) Expansion of war and economic relief expenditures

As many as five Diet sessions were held to decide and add to the budget for fiscal 1932 that marked the conversion from austerity finance. Prime Minister Inukai and Finance Minister Takahashi examined the draft budget of the former Wakatsuki Cabinet and decided the draft budget for fiscal 1932 totaling about 1.4 billion yen under the policy that consisted of discontinuing transfers to sinking funds for the redemption of bonds and tax increases and allocating additional budget funds to new policies. The 60th Imperial Diet session in which the Minseito Party members accounted for a majority was dissolved on January 21, 1932. The draft budget submitted by the Inukai Seiyukai Cabinet

had failed to pass, and Finance Minister Takahashi compiled an operating budget totaling 1.46 billion yen. (Table 1)

During the general election in February, the Seiyukai Party appealed to the public with “which will you choose, the Minseito Party of economic recession or the Seiyukai party of economic recovery.” As a result, the Seiyukai Party won an absolute majority by increasing its number of seats from 171 before dissolution to 303. In contrast, the Minseito Party lost 103 seats, from 247 to 144. In accordance with the provisions of Article 70 of the Constitution, Prime Minister Inukai obtained *ex post facto* approval of an extraordinary Imperial Ordinance at the 61st Diet session, which started on March 18, with respect to the issue of government bonds totaling 70 million yen during the period from January to March to cover the expenses of the Manchurian Incident, which was implemented under this Imperial Ordinance. Furthermore, the Manchurian Incident Public Bond Law to procure the expenses of 67.50 million yen for April and May was passed during this Diet session.

As shown in Table 1, the full-scale addition of estimated expenditures was implemented after the May 15 Incident in 1932 in which Prime Minister Inukai was assassinated. An Imperial mandate was issued to Makoto Saito, the former minister of the navy, to form a new Cabinet. Supported by the entire nation, the Saito Cabinet took steps to approve Manchukuo that was just founded on March 1, 1932. Re-appointed Finance Minister Takahashi included the expenses for the Manchurian Incident covering the period until January of the following year as an additional budget, and proposed estimated expenditures of 1.78 billion yen for fiscal 1932. This meant a decision on the issue of Japan’s first deficit-covering bond.

**Table 1. Estimated Expenditures for Fiscal 1932**

(Unit: Million yen)

Unofficial announcement to each ministry by Finance Minister Inoue	October 1, 1931	1,332
Estimate created by the Wakatsuki Cabinet	December 7, 1931	1,479
Budget submitted by the Inukai Cabinet that failed to pass	December 27, 1931	1,397
Budget for the previous fiscal year <sup>Note</sup>	January 21, 1932	1,488
Operating budget	February 2, 1932	1,461
The 61st Diet session	March 25, 1932	1,461
The 62nd Diet session	June 15, 1932	1,780
The 63rd Diet session	August 22, 1932	1,944
The 64th Diet session (final operating budget)	December 24, 1932	2,018
(Reference) Expenditures after account closing for fiscal 1930		1,557
(Reference) Expenditures after account closing for fiscal 1931		1,477
(Reference) Expenditures after account closing for fiscal 1932		1,950
(Reference) Expenditures after account closing for fiscal 1933		2,255

Note: Because the draft budget submitted by the Inukai Cabinet failed to pass the Diet due to the dissolution of the 60th Diet session, the budget for the previous fiscal year was to be implemented.

Source: *Showa zaisei shi* (Financial History of Showa), edited by the Office of Financial History of Showa of the Ministry of Finance, Volume 3, Toyo Keizai, 1995.

Finance Minister Takahashi noted in his financial address at the 62nd Imperial Diet session (June 3) that “despite the significant reduction in revenue for fiscal 1932 due to the depression of business activities, the disbursement of the expenses necessary to conduct state affairs cannot be avoided. (Omitted.) In addition to the issue of business public bonds and Manchurian Incident public bonds that are currently issued in accordance with the laws concerning public bond issuance, it has become unavoidable to newly issue revenue supplementing public bonds. (Omitted.) These new bonds would be accepted by the Bank of Japan, the Treasury Deposit Bureau of the Ministry of Finance and by using other funds available within the government. It is our policy to avoid the public offering of these new bonds on the general market.”

On the next day (June 4), Finance Minister Takahashi explained the reason for proposing a bill to expand the guaranteed issue limit of the Bank of Japan notes as “there is not a little inconvenience in smoothly supplying the money required for legitimate transactions of Japanese industry.”

In addition, at the 63rd Diet session, the Saito Cabinet announced on August 25 measures requiring a total of 1.6 billion yen, including the amounts allocated to regional areas. By being referred to as “tiding over difficult times,” these measures to provide solutions to the agricultural depression consisted of a total project scale of 800 million yen in three years, debt consolidation and loans on the security of real estate. Of this amount, an addition to the general account of 163 million yen for fiscal 1932 was proposed. Furthermore, the expenditures of the Manchurian Incident for February and March were added at the 64th Diet session in January 1933. Consequently, the operating budget for fiscal 1932 had become 2.018 billion yen. During this Diet session, a draft budget for fiscal 1933 with expenditures of 2.239 billion yen was also submitted.

In this way, the expenditures in the general account (on an after account closing basis), which were significantly reduced by 10 percent and 5 percent respectively in fiscal 1930 and fiscal 1931 under the initiative of Finance Minister Inoue, rapidly increased by 32 percent and 16 percent, respectively, in fiscal 1932 and fiscal 1933. The dependence on government bonds also increased from 7.8 percent in fiscal 1931 to 32.3 percent in fiscal 1932. These indicators suggest a shift to expansionary financial measures in fiscal 1932 by the addition of the expenditures for the Manchurian Incident and the expenses to tide over difficult times.

## (2) Relief expenses were limited to three years

With respect to such expansion of expenditures, Kiyosaku Nishino, a journalist, noted that economic measures adopted by Finance Minister Takahashi are not those adopted deliberately and that “his real intention is not enthusiastic about tiding over difficult times.”<sup>14</sup>

Takahashi himself said in March 1934 that “it was decided from the beginning at the ministerial meeting that the projects to tide over difficult times were limited to three years. Because fiscal 1932 was the first year, it was not possible to immediately use a large amount of money. It was fiscal 1933 when the largest amount of money was required. The required amount would be gradually reduced when we entered fiscal 1934. (Omitted.) I would use these funds for projects that can be completed in three years.”<sup>26</sup>

With respect to local finance, Takahashi pointed out that “under the current situation, municipalities that should cultivate a big tree (nation) have forgotten their duties and have simply depended upon a big tree. This is why national finance is in a crisis.”<sup>26</sup> This criticism also applies to Japan early in the 21st century.

Finance Minister Takahashi was consistent in not resorting to tax increases. At the Imperial Diet sessions, etc., Takahashi repeatedly stated that “planning tax increases or formulating other plans to increase revenue would result in nipping the finally burgeoning bud today when the economy has just begun to recover. It is not yet time to plan such steps in view of the general situation.” Regarding this statement, Nishino pointed out that “if there is a source of revenues, the military authorities will inevitably demand the funds. His thought was to restrain such a demand on the grounds that there is no source of revenues.”<sup>14</sup>

With respect to tax increases, Finance Minister Masanobu Fujii (the former vice minister), who succeeded Takahashi when Takahashi retired as Finance Minister due to the Teijin bribery case, introduced the provisional profits tax. Subsequently, after Takahashi was assassinated in the February 26 Incident, Finance Minister Ei-ichi Baba implemented a tax increase.

## (3) Recovery based on expanded exports and capital investment

In the shift to expansionary finance, an economy that had long been sluggish was directed toward recovery. For example, the production of the mining and manufacturing industries dropped sharply in 1931 by 9.2 percent. Subsequently, it increased significantly by 7 percent in 1932 and 13 percent in 1933. Wholesale prices, which had dropped by as much as 15.4 percent in 1931, increased sharply by 5.3 percent in 1932 and 11.4 percent in 1933. The real economic growth rate that hovered at a level of slightly less than 1 percent during the period from 1929 to 1931 rapidly recovered to 4.4 percent in 1932 and 10.1 percent in 1933. These indicators are frequently interpreted to mean that the expansionary finance headed by Finance Minister Takahashi brought about economic recovery.

However, economic recovery was by no means solely dependent on the expansion of government spending. It can be seen that conditions had already been set towards autonomous recovery of the economy. Under

such circumstances, the re-embargo of gold exports and monetary relaxation accelerated by yen depreciation brought about a reactionary rise in prices, which facilitated economic recovery. What served as an impetus was not government spending, but was the abolition of the gold standard and a low interest rate.

In actuality, while government spending on a real gross domestic product (GDP) basis increased in 1932 and 1933, it remained at the same level thereafter until 1936. When we look at the ratio of government spending to nominal GDP, its significant increase was not seen until 1937 when the Sino-Japanese War broke out. Accordingly, a rise in the real economic growth rate is largely attributable to increases in capital investment and exports in the private sector.

As a background factor behind the shift to the expansion of investment in the private sector, the fact that progress was made to a substantial extent in the elimination of the shadow portions of the Japanese economy cannot be ignored, including progress in the consolidation of banks pursuant to the Bank Law in 1927 and progress in the restructuring of companies and in the disposal of bad debts under the austerity finance policy adopted by Inoue. The following recovery processes can be considered. In addition to such streamlined business management, the acceleration of yen depreciation after the re-embargo of gold exports brought about the recovery of exports. Coupled by the low interest rate policy taken by Finance Minister Takahashi, recovery was made in capital investment.

As shown in Figure 3, in terms of the ratio to GDP, the amount of newly issued government bonds gradu-

ally decreased up to fiscal 1936 after reaching a peak in fiscal 1932. The Bank of Japan purchased 86 percent of government bonds worth 3.9 billion yen that were issued during this period, and 91 percent of these bonds were sold on the open market.

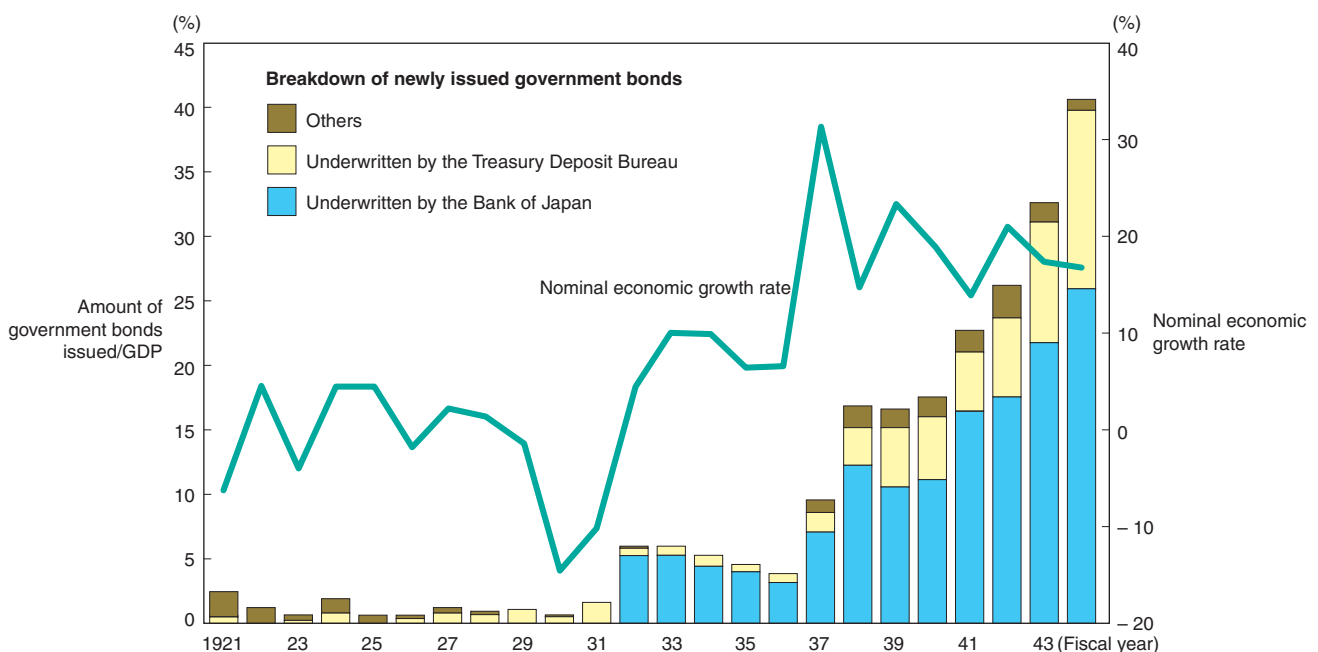
If we only consider the period when Finance Minister Takahashi was in office, it can be said that economic recovery was achieved without accelerating inflation. Nevertheless, it is not true to say that such economic performance was brought about by expansionary financial measures. Rather, the escape from deflation is largely attributable to the implementation of a low interest rate policy by abolishing the gold standard.

## II Why Was Underwriting of Government Bonds by the Bank of Japan Implemented?

The issue of long-term government bonds purchased by the Bank of Japan started on November 25, 1932. The purposes for such issue were to easily finance increasing expenditures, to increase money supplies that shrunk by the lifting of gold exports and to lower interest rates. Accordingly, the direct purchase of government bonds by the Bank of Japan was highly evaluated as “an excellent three-bird-one-stone solution.”

This mechanism is outlined below. The Bank of Japan purchases government bonds with a low interest rate. The funds obtained by selling government bonds are used for government spending. The expanded government

**Figure 3. Nominal Economic Growth Rate and Ratio of Amounts of Newly Issued Government Bonds to GDP**



Sources: *Showa zaisei shi* (Financial History of Showa), edited by the Office of Financial History of Showa of the Ministry of Finance, Volume 6, Toyo Keizai, 1954; Kazushi Okawa, Nobukiyo Takamatsu, Yuzo Yamamoto, *Choki keizai tokei 1, kokumin shotoku* (Long-Term Economic Statistics 1: National Income), Toyo Keizai, 1974; *Meiji iko honpo shuyo keizai tokei* (The Key Economic Statistics of Japan in and after Meiji), the Statistics Bureau, the Bank of Japan, 1966.

spending accelerates monetary relaxation. In keeping pace with such expedited monetary relaxation, the Bank of Japan sells government bonds, thereby enabling both the issue of a large amount of government bonds and a low interest rate. As far as the market anticipates the lowering of an interest rate, the Bank of Japan can sell government bonds, and the government can issue government bonds without being restricted by the market.

The evaluation of Finance Minister Takahashi who started such a direct underwriting of government bonds by the Bank of Japan is divided: one is that this scheme invited a cumulative rise of government bonds and inflation and the other is that he was bravely committed to gradually decreasing government bonds. For example, in December 1932 immediately after the start of the underwriting of government bonds by the Bank of Japan, Hyoe Ouchi pointed out that “the economic implication of government bonds worth 10 billion yen (the outstanding amount) is extremely extensive, and such implication expands with time. In particular, this would inevitably invite a fairly large inflation.”<sup>8</sup>

At the same time, Ouchi and Tokuzo Aoki noted in the foreword of *Showa zaisei shi* (Financial History of Showa), Volume 6, that “in spite of his advanced age, Finance Minister Takahashi supported the lifeline of Japanese finance that was about to collapse.”<sup>12</sup> If compared to the vast cumulative rise of government bonds after the February 26 Incident, the policy to gradually decrease government bonds that was adopted before that incident might be seen as sound.

However, didn't they perceive any danger that the purchase of government bonds by the Bank of Japan that was adopted as a “temporary expedient” might become a permanent measure and might be expanded? *Nihon ginko hyakunen shi* (the Hundred Year History of the Bank of Japan) included a statement that “it is highly regrettable that this bank agreed in the autumn of 1932 on the implementation of the method in which this bank underwrites government bonds in the sense that such implementation marked the first step in eventually depriving this bank of the central banking function.”<sup>29</sup>

Accordingly, the following section examines the background behind the implementation of the unprecedented policy of direct underwriting of government bonds by the Bank of Japan, which was regarded by the Bank of Japan itself as the largest blunder in the history of the Bank of Japan. Whether an exit strategy concerning such measures was envisioned is also examined below.

## 1 Was an Option of Public Offering Available?

Before starting a study on what policy options were available at the time, the following paragraphs examine

the period when the adoption of the method of direct underwriting of government bonds by the Bank of Japan was decided.

As noted previously, Finance Minister Takahashi announced a policy of the underwriting of government bonds by the Bank of Japan at the Diet session on June 3, 1932. According to *Showa zaisei shi* (Financial History of Showa), before this announcement, “at the meeting with banks on February 16, 1932, Finance Minister Takahashi suggested a policy of not publicly offering government bonds.”<sup>12</sup> *Showa kyoko no kenkyu* (Research on the Showa Depression) introduced a newspaper article that reported Finance Minister Takahashi's policy that war bonds as well as other newly issued public bonds would be underwritten by the Bank of Japan, which was announced at the conference to discuss the current situation held by the Bank of Japan on March 9.<sup>6</sup>

Furthermore, based on the records stored in the Bank of Japan, Eisaku Ide also pointed out that the underwriting of government bonds by the Bank of Japan was planned in a specific manner by not later than April 1932 because of the comments made at the meeting of branch managers of the Bank of Japan on April 18, 1932 that “the current government consideration is to cover expenditures excluding war expenses by the special account without publicly offering government bonds. The government plans to let the Bank of Japan purchase government bonds to cover war-related expenses.”<sup>3</sup>

When we review the government bond market from the end of 1931 when Korekiyo Takahashi took office as Finance Minister to around April 1932, we find that the price of the *Ko* 5-percent interest-bearing public bond hovered around the level of 87 yen as being influenced by a worldwide financial crisis in May 1931, the abolition of the gold standard by the United Kingdom in September, the Manchurian Incident and the lifting of the gold embargo.

The offering of government bonds on the market was suspended prior to this period. In preparation for the lifting of the gold embargo, the issue of new government bonds was restrained, and if such new government bonds were issued, they were purchased by the Treasury Deposit Bureau of the Ministry of Finance (now the Trust Fund Bureau). With respect to the offering of newly issued bonds in the open market, the 47th 5-percent interest-bearing treasury bond was the last bond that was issued in March 1928 to procure funds to finance expenses for earthquake disaster reconstruction. Subsequently, the bonds offered in the open market were limited to refinancing bonds.

Even for refinancing bonds, banks were requesting shortening of the maturity. The conditions for the 36th 5-percent interest-bearing treasury bonds issued in November 1926 included: an issue amount of 60 million yen, maturity of 12 years, an issue price of 91.75 yen in

case of cash payment, and a yield of 6.19 percent. In August 1928 when monetary relaxation was accelerated, it was possible to issue the 48th 5-percent interest-bearing treasury bonds worth 230 million yen with a maturity of 28 years, an issue price of 98 yen in case of cash payment and a yield of 5.14 percent. However, following this, the syndicate strongly opposed refinancing at a low interest rate and a long-term maturity even when the price of government bonds rose sharply around the time the gold embargo was lifted.

The 17th 5-percent interest-bearing treasury bond (issued in September 1924) reaching maturity on September 1, 1931, could not be converted to 4.5-percent interest-bearing government bonds even under the trend of the lowering market interest rate. Consequently, this bond was refinanced as the 58th 5-percent interest-bearing treasury bond with an issue amount of 88 million yen and a maturity of 17 years and 9 months.

The maturity of the 60th 5-percent interest-bearing treasury bond issued in May 1932 was reduced to 7 years and 3 months, and the issue price was also reduced to 94 yen in case of cash payment. By contrast, the Treasury Deposit Bureau underwrote the 5-percent interest-bearing public bond worth 50 million yen under the conditions of a maturity of 55 years and an issue price of 86.6 percent of face value to finance the expenses required by the Manchurian Incident on May 24, which is the day following the day that this refinancing bond was issued.

As such, despite the fact that the procurement of a huge amount of funds was necessary, such as expenditures required by the Manchurian Incident, revenue supplementation and expenses for projects to tide over difficult times, it was difficult to raise new funds from the market. The Treasury Deposit Bureau, which had increased its underlying assets through a rapid increase of postal savings at the time of a financial crisis in 1927, already owned an enormous amount of government bonds. This is because, in addition to underwriting new government bonds, the Treasury Deposit Bureau was purchasing government bonds from the market to maintain market prices. In addition, it was also underwriting municipal bonds and industry encouragement bonds to facilitate local economies. For these reasons, it appears that there was little room for the government to raise funds from the market through public offerings or from the Treasury Deposit Bureau by using government bonds.

## 2 Temporary Lending from the Bank of Japan Had Occurred in the Past

There was a case in the past in which, when it became difficult for the government to raise funds, the Bank of Japan loaned funds to the government. The government used such funds for necessary spending and subse-

quently returned such funds to the Bank of Japan. This method was used immediately after the Sino-Japanese War and the Russo-Japanese War. As indicated by Masaru Takeda,<sup>27</sup> loans to the government were repaid by reparations after the Sino-Japanese War and by issuing bonds in foreign currencies after the Russo-Japanese War.

These methods to repay funds to the Bank of Japan were not available after the Manchurian Incident. The only measure available was to issue government bonds in the domestic market to raise funds. However, as explained previously, it was obviously difficult to raise a huge amount of funds in the overloaded domestic government bond market. Accordingly, the government at that time might have considered that it would serve as the same function if the Bank of Japan were to underwrite government bonds and subsequently sell such bonds in the market.

Eigo Fukai noted, “in 1932, purchases by subscription of most bonds by a syndicate became difficult. It was further difficult to expect the public offering of bonds in place of underwriting by a syndicate. If most government bonds that are issued through purchases by subscription and/or public offerings are subsequently purchased by the Bank of Japan, this situation will be regarded as failure and may damage the credibility of government bonds, thereby further inviting the feeling of dislike for government bonds. Accordingly, it was considered that it would be better to issue government bonds on condition that all of these government bonds be purchased by the Bank of Japan, and that the Bank of Japan would then sell them to persons who want to buy such bonds.”<sup>33</sup>

Korekiyo Takahashi noted in March 1934 “the issue of public bonds may continue for a year, two years or three years. However, because these funds are necessary at any cost, the method of selling bonds directly to the public will lag far behind the intended purpose. (Omitted.) Therefore, I decided to first let the Bank of Japan purchase the bonds.”<sup>26</sup>

## 3 Underwriting of Government Bonds on the Assumption of Open Market Selling Operation

Even under the situation that the public offering of a huge amount of government bonds or their acceptance by the Treasury Deposit Bureau is difficult, why did the Bank of Japan agree on underwriting government bonds? In the past, it appears that the underwriting of government bonds by the Bank of Japan was interpreted based on the hypothesis that banking is subordinate to public finance. For example, Fukai, the Deputy Governor of the Bank of Japan, suggested monetary relaxation to Finance Minister Takahashi through the buying operation of the Bank of Japan, and purchases of government bonds by the Bank of Japan were

implemented based on the innovative idea of the finance minister.<sup>34</sup>

The interpretation of Masanao Ito was that the Bank of Japan strongly agreed on the purchase of government bonds by the Bank of Japan as a measure to facilitate harmony between fiscal needs and financial policy, and actively cooperated with the government's expansionary policy.<sup>4</sup> Furthermore, Eisaku Ide explained in detail the aspect that the Bank of Japan positively accepted the scheme of purchasing government bonds on the assumption of open market selling operation from the standpoint of pursuing strategic profits of the Bank of Japan that were ignored under the conventional subordinate banking hypothesis.<sup>3</sup>

Beginning in February 1930, immediately after the lifting of the gold embargo, the Ministry of Finance and the Bank of Japan continued studies on amendments to the Bank of Japan system through joint study meetings. Capital outflow from Japan increased by the lifting of the gold embargo, and gold and foreign currency reserves decreased. Because of this, the issue of the Bank of Japan notes for which the specie reserves were secured decreased, and the extra issue of the Bank of Japan notes for which a high issue tax was imposed had become the normal condition. To deal with this situation, it was decided to substantially expand the issue limit with guaranteed reserves to make it possible to flexibly issue extra bonds. In the course of discussions to reach agreement on this point, the Bank of Japan took the position that it would impose a restriction on the ownership of government bonds as guaranteed reserves for issuing the Bank of Japan notes, but it would not impose a limit on the total amount of government bonds owned.

As the reason for the Bank of Japan to actually waive an ownership restriction, Ide assumed that a policy that an increase in the amount of government bonds owned would lead to an increased issue of currency was unrealistic because the government adopted the gold standard. He pointed out that there already was a theoretical foundation for accepting the scheme of underwriting government bonds under the gold standard.<sup>3</sup> In actuality, there was a case where the Bank of Japan purchased all of the discount extraordinary treasury bonds worth 50 million yen with maturity of one year that were issued in October 1917. These bonds were then sold chiefly to banks. Ide further noted that because the Ministry of Finance and the Bank of Japan both agreed on positioning "subscription, underwriting, selling and/or purchase of government bonds" as duties of the Bank of Japan in 1930 at the joint study meeting, the thought already existed that the Bank of Japan could strengthen intervention in the financial market and manage liquidity by eliminating the need for permission by the finance minister for monetary control by the open market selling operation of government bonds.<sup>3</sup> Actually, when we see the financial situation

after the lifting of the gold embargo, we find that the demand for funds by companies was sluggish under the prolonged depression, and five major banks (Mitsui, Mitsubishi, Sumitomo, Daiichi and Yasuda) had a large amount of surplus funds.

However, because the Bank of Japan did not have a political means of reserve ratio operations at that time, it had no countermeasures against the major banks having further increased surplus funds by purchasing dollars. Accordingly, it can be presumed that in order to increase market control ability, the Bank of Japan acquired a political means of open market selling of government bonds by making a compromise of underwriting government bonds.

#### 4 Impact of Open Market Operations in the United States and the United Kingdom

It also cannot be denied that the open market operations that began to be adopted as a new method of monetary control in the United Kingdom and the United States had an impact on Japan.

In the 1890s in the United Kingdom, the Bank of England had already started the selling operation of consols under repurchase agreements. The principal feature of this operation was that loans with a time limit were provided to banks, rather than open market operations. In the 1920s after World War I, the number of commercial bills decreased in the short-term financial market, and securities issued by the Her Majesty's Treasury started to account for the majority.

According to Sayers, during the early years of the Governor Norman era (1920 to 1944), the Bank of England rarely handled commercial bills and started to implement the selling and buying of securities issued by Her Majesty's Treasury to exert an impact on the market interest rate. These operations started to be called open market operations. Subsequently, in 1928, the issue of bank notes was solely handled by the Bank of England, and the Bank of England owned government bonds as assets that corresponded to the issued bank notes. By using these government bonds, the Bank of England started to implement open market operations.<sup>2</sup> Following this, the concept of using open market operations, rather than official discount rate operations, in response to transitory changes in the financial situation became widely accepted.

Furthermore, the Macmillan Report that was issued in July 1931 immediately before the abolition of the gold standard proposed the adoption of open market operations targeted at the selling and buying of long-term government bonds. This proposal distinguished long-term and short-term interest rates, and can be so interpreted that theories traced back to Keynes' monetary theory, which focuses on control of long-term interest rates by the central bank, were reflected in this proposal. Subsequently, the Bank of England increased

the money supply by implementing open market operations in April and May 1932, and refinanced government bonds.<sup>2</sup>

In the United States, the Federal Reserve Bank, established in 1913, was conducting monetary control by commercial bills (real bills) that were generated by property and service transactions such as bank bills and trade bills. In 1917, pursuant to the Special Deposit of Public Money Act, it became possible to purchase government bonds by using the funds in the government deposit account established in commercial banks. The Federal Reserve Bank started to provide the funds by buying government bonds for any shortage in the reserve deposit of commercial banks as a result of such purchases of government bonds.

Subsequently, the economy fell into a post-war depression in 1920 and 1921 after World War I. As a reason for the depression, the collapse of the inventory boom that was financed by the discount of a large amount of real bills was pointed out and a review of the Real Bills Doctrine was proposed. At this time, the issue of government bonds increased due to World War I. Influenced by these two factors, the supply of funds by the Federal Reserve Bank through the purchases of government bonds was accelerated.

There was also a criticism that the purchases of government bonds by the Federal Reserve Bank meant opening the door to inflation. However, according to Marshall, meetings of the presidents of the Federal Reserve Bank of each region began in May 1922 concerning the purchase of government bonds.<sup>1</sup> Subsequently, this meeting developed into the Federal Open Market Committee (FOMC).

Under the circumstances where the issue of real bills had decreased substantially due to a major crisis lasting from the autumn of 1929, the issue of Department of the Treasury securities began in December 1929. Accordingly, the target of the buying operation by the Federal Reserve Bank was shifted from real bills to Department of the Treasury securities. In the spring of 1933, the Federal Reserve Bank was vested with the role of purchasing government bonds up to 1 billion dollars if necessary when government bonds are issued.

Japan also faced an economic situation in which there were almost no targets of bill operations. In light of such a situation, Eigo Fukai considered it doubtful for the Bank of Japan to compete with general banks by directly handling the buying and selling of commercial bills. He noted the need for open market operations by government bonds by saying that “it is an appropriate measure to establish close contact with the financial market through the purchase and sales of government bonds by the Bank of Japan. While it is better if both purchases and sales can be realized in the future, for the time being this operation will meet the purpose of supplying funds by concentrating on the purchase of government bonds.”<sup>34</sup>

## 5 Underwriting by the Bank of Japan, Rather than Buying Operation

The following section compares the buying operation of government bonds that was proposed by Deputy Governor Fukai to Finance Minister Takahashi and the open market selling of government bonds after being underwritten by the Bank of Japan.

Junichiro Nishimura, who served as Manager of the Government Debt Division, the Financial Bureau of the Ministry of Finance, from December 1932 to March 1936, noted that “Deputy Governor Fukai suggested to Finance Minister Takahashi that banks have so far substantially accumulated public bonds. If the Bank of Japan purchases such bonds, the corresponding amount of money will be released to the market; such money may be effectively used as operating funds required in the industry. In response, Finance Minister Takahashi noted that if public bonds already issued are purchased, new government bonds to finance the Manchurian Incident and/or to cover other financial needs could not be successfully issued because of the limited funds available. Rather, if the Bank of Japan underwrites newly issued public bonds, the corresponding amount of money will be released to the market.”<sup>14</sup>

Eisaku Ide pointed out the difference in the effect of monetary relaxation between the underwriting by the Bank of Japan and the buying operation of government bonds as follows.<sup>3</sup> Underwriting by the Bank of Japan will lead to an increase in the money supply through the creation of demand by distributing government spending. However, in the case of buying operation of government bonds, the commercial bank’s current account balances at the Bank of Japan will increase by such an operation, and the base money (total of cash and current account balances at the Bank of Japan) will correspondingly increase by the amount of such operation. However, such increases will not lead to an increase in the money supply if loans to the private sector are not increased.

However, the difference between implementation of the buying operation after the issue of government bonds and implementation of open market selling operations after underwriting by the Bank of Japan cannot be generated if both of these measures are implemented on a continued basis. Fukai wrote that “it was decided to underwrite newly issued government bonds instead of my suggestion of the purchase of government bonds already issued; these measures amount to the same thing from the standpoint of money supply.”<sup>34</sup>

The basic difference between the two methods is obvious, i.e., which is more convenient for the government to raise funds in issuing government bonds. In *Kinhon’i sei ridatsu go no tsuka seisaku* (Currency Policy after the Abolition of the Gold Standard), Fukai pointed out that “if national expenditures are financed by tax revenues and/or the public offering of government

bonds, we immediately face a certain limit in case of an excess burden of taxes or unsuccessful public offering. (Omitted.) As the Bank of Japan can technically underwrite and own any amount of government bonds, we do not see any explicit limit from this standpoint. (Omitted.) Careful attention is required to use this method. (Omitted.) It is presumed that there were some relationships with the policy to gradually decrease the amount of government bonds issued when Takahashi originated the method of underwriting by the Bank of Japan.”<sup>33</sup>

In this way, the underwriting of government bonds by the Bank of Japan on the assumption of open market selling began. However, did the underwriting of government bonds by the Bank of Japan and a policy to gradually decrease government bonds explicitly coexist from the beginning? In *Kaiko nanajyu nen* (Memories of 70 Years), Eigo Fukai also noted “the underwriting of government bonds by the Bank of Japan and the gradual decrease in the amount of government bonds issued existed side by side from the beginning as the objectives in Finance Minister Takahashi’s financial plan.”<sup>34</sup> This statement was made after the emergence of the adverse effects of the underwriting of government bonds by the Bank of Japan in the same way as indicated in his book previously mentioned.

At the 64th Diet session, Finance Minister Takahashi submitted the draft budget for fiscal 1933, and noted on January 21, 1933, that even if deficit-covering bonds reach a huge amount only in fiscal 1933, the annual account (revenue and expenditure) would be balanced in fiscal 1935. However, *Showa zaisei shi* (Financial History of Showa) indicated that he did not offer any supporting facts for his statement.<sup>10</sup>

While the amount of government bonds issued decreased in fiscal 1934 and fiscal 1935, it was the budget compilation policy for fiscal 1936, which was announced on June 25, 1935, that first explicitly stated the gradual decrease of public bonds in the budget compilation policy that was determined at a ministerial meeting. The statement of this policy included that “the amount of public bonds to be newly issued should be reduced by deducting the estimated natural revenue growth in the budget for fiscal 1936 from the amount of new public bonds to be issued in the budget for fiscal 1935.”<sup>10</sup>

By expressly saying that he forgot to mention an important thing, Nishimura added, “it appears that at first Finance Minister Takahashi did not think of the policy of a gradual decrease in the public bonds.”<sup>14</sup>

As such, if that the policy of a gradual decrease in the government bonds was explicitly stated at the start of the underwriting of government bonds by the Bank of Japan is merely supposition, the open market selling of government bonds by the Bank of Japan, i.e., the situation of resale of government bonds, must have had an extremely important meaning in considering the limit of the underwriting of government bonds by the Bank of Japan.

### III Changes in Selling Operations and Further Absorption of Government Bonds

The selling price used in the open market selling of government bonds by the Bank of Japan was based on the issue price under the principle of preserving the government bond market. Essentially, this method constituted the issue of long-term government bonds.

Based on the records kept by the Bank of Japan, Kinzo Shima pointed out that in selling government bonds underwritten by the Bank of Japan in the open market, the Bank of Japan made decisions on the sales of government bonds in response to requests by financial institutions in the private sector after considering the current financial situation, the amount of funds owned by the bank seeking to purchase the government bonds and especially whether such purchases might stiffen the call market.<sup>23</sup> In addition, because it had become easy to issue government bonds through underwriting by the Bank of Japan, Ministry of Finance securities were not issued after October 1933, and even had no longer become the target of open market selling (best-effort sale).

As such, the selling of government bonds by the Bank of Japan differed significantly from the open market operations to trade government bonds and short-term government securities for monetary control in the United States and the United Kingdom.

Simultaneously with the start of the underwriting of government bonds by the Bank of Japan in November 1932, the coupon rate of government bonds issued was reduced from 5 percent (maturity of 37 years) to 4.5 percent (maturity of 12 years). These bonds, worth 200 million yen, were underwritten by the Bank of Japan as 1 4.5-percent interest-bearing treasury bonds with an issue price of 96.5 percent of face value. The demand for funds among companies remained sluggish. On July 3, 1933, the official discount rate was reduced to a daily interest rate per 100 yen of 1 *sen* (an annual interest rate of 3.65%), which had accelerated a decline of issue interest rates of government bonds. In August 1933, the market price of the 4.5-percent interest-bearing government bonds had become over par (with premium). In September, the Bank of Japan underwrote 300 million yen of 4-percent interest-bearing treasury bonds with a maturity of 24 years at 98.5 percent of face value.

#### 1 Occurrence of Changes in Selling Operations

Such “smooth” absorption of government bonds started to show signs of change in 1935. Through the penetration of monetary relaxation and the increase in exports

as a result of yen depreciation, the economy that had bottomed out in mid-1932 continued to expand. Concurrently with a shift of bank loans to an increasing trend starting in the latter half of fiscal 1935, the demand for government bonds decreased. The trend in prices (over the previous year) based on the Tokyo retail price index followed a stable path of 1.0 percent in 1932, 6.4 percent in 1933 and 2.1 percent in 1934, while fluctuating up and down as indicated in Figure 4. From the summer of 1935, an explicit rising trend started to be seen.

The selling of government bonds by the Bank of Japan proceeds smoothly in anticipation of a lowering interest rate, and plays a major role in absorbing surplus funds. However, if the prospect of an increasing interest rate of government bonds appears, the sales of government bonds come to a standstill and the amount of government bonds owned by the Bank of Japan increases. Consequently, the supply of high-powered money (base money) increases. Through a further rise in inflationary expectations, the prospect for an increasing interest rate is further increased.

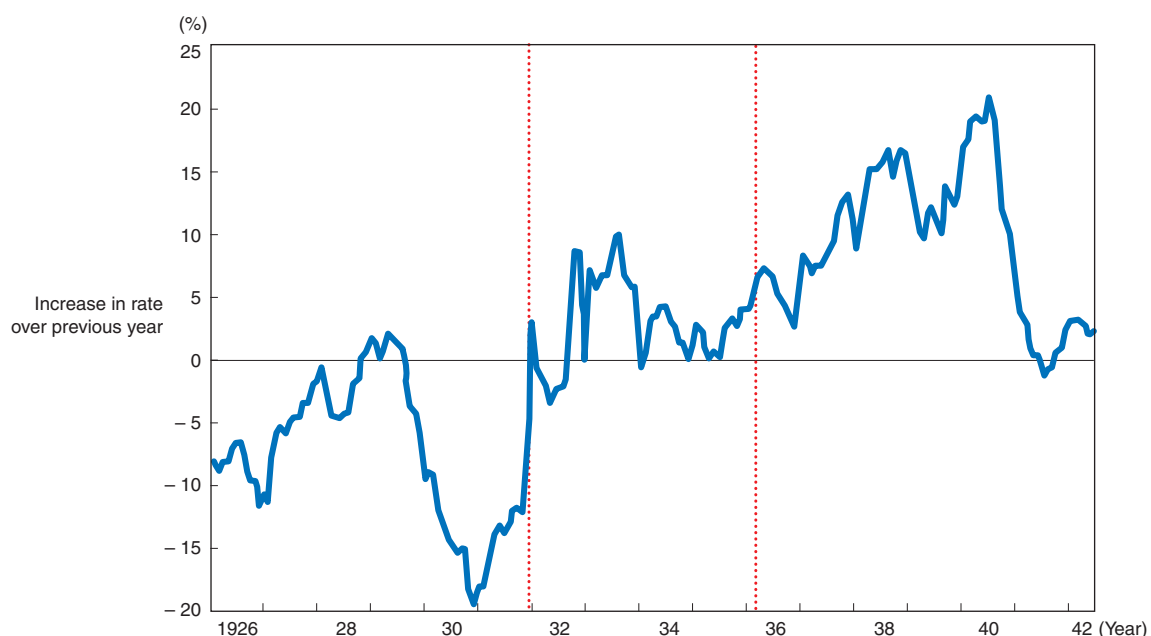
Accordingly, the resale rate (the sale rate in Figure 5) that shows to what extent long-term government bonds underwritten by the Bank of Japan are being sold on the market serves as an important indicator that shows the ability of the market or Japanese economy to absorb government bonds. As indicated in Figure 5, this rate was at its highest level in 1934, but declined in 1935. In terms of the first and second halves of the calendar year, it was 58.0 percent from July to December 1935 and declined to 43.9 percent from January to June 1936.

Finance Minister Takahashi, who stood at the turning point of whether the amount of government bonds issued should be decreased, explained at a ministerial meeting on June 25, 1935, which was mentioned previously, that the time had come to gradually reduce the amount of government bonds issued by saying that “when a huge amount of public bonds are issued every year, financial companies that already have a substantially large amount of public bonds feel a sense of unease; if even a small decline in public bond prices is projected, they will not, of course, be willing to increase the amount of public bonds they own and might feel like selling those they already own. If such a situation should occur, it will expand at an accelerating pace, instantly disrupting the public bond policy, making it impossible to expect the market to absorb public bonds.”

In addition, according to *Showa zaisei shi* (Financial History of Showa), Finance Minister Takahashi issued a warning on July 26 that “if public bonds are not absorbed by general financial institutions, etc., and if the Bank of Japan is burdened with such public bonds, it clearly indicates a stalemate of the public bond policy, and an evil effect of vicious inflation might emerge . . .”<sup>12</sup> Accordingly, Finance Minister Takahashi compiled the budget for fiscal 1936 under the policy of “reducing public bonds by an increase in ordinary revenues.”

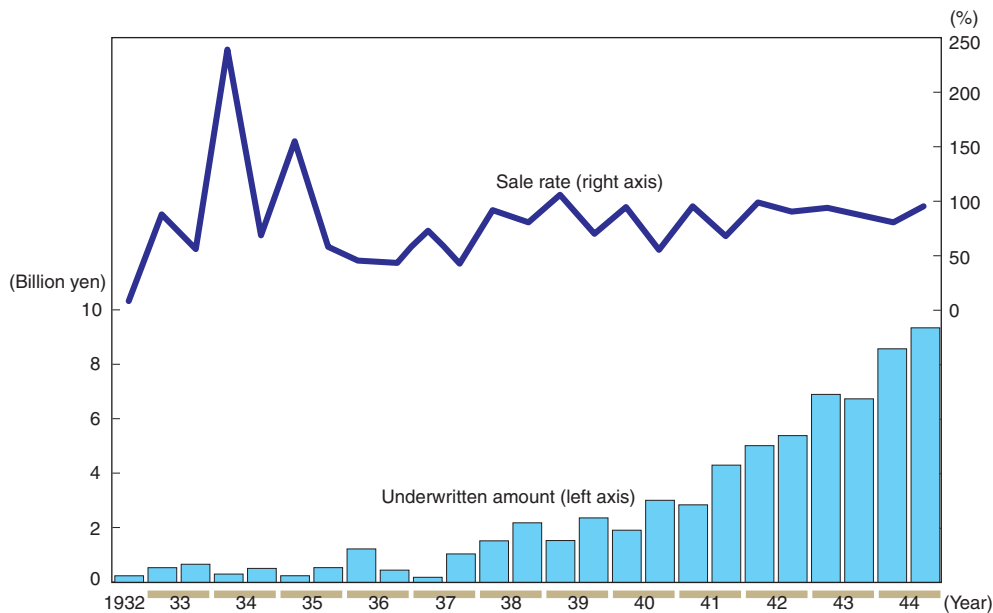
Discussions between the “military and the Ministry of Finance” concerning the budget for fiscal 1936 could not reach agreement at the working level. The ministerial meeting held at the end of November 1935 also faced confusion due to the strong request of the military authorities for expansion, and lasted a total of

**Figure 4. Trend of Consumer Prices**



Notes: (1) Tokyo retail price index. (2) The dotted vertical lines indicate the Takahashi finance period (December 1931 to February 1936).

Source: *Kin'yu jiko sankosho: Showa 2 nen shirabe – 17 nen shirabe* (Reference Book for Financial Records: Survey in 1927 – Survey in 1942), edited by the Financial Bureau of the Ministry of Finance, Yushodo Co., 1993.

**Figure 5. Amount of Government Bonds Underwritten by the Bank of Japan and the Market Sale Rate**

Notes: Total figure for November and December is used for 1932; others represent the first half and second half of the calendar year.

Source: *Nihon ginko hyakunen shi* (The Hundred Year History of the Bank of Japan), edited by the Editorial Committee of the Hundred Year History of the Bank of Japan, Volume 4, the Bank of Japan, 1984.

36 hours with repeated interruptions. During this meeting, Finance Minister Takahashi strongly contended that “if we are devoted to national defense only and invite vicious inflation and if our financial credibility is damaged, national defense as well can by no means be stable and strong.”

However, the decrease in the amount of government bonds issued that could result in the reduction of war expenses invited rebellion of the military intending to advance into the Continent of China, and Finance Minister Takahashi was assassinated in the February 26 Incident in 1936. Subsequently, under the slogans of “implementation of Manchurian policy,” “enhancement of national defense,” “economic rehabilitation in agricultural, mountain and fishing villages” and “major taxation reform,” government spending continued to expand. Government spending started to compete with funds in the private sector and the rate of expected inflation increased. The resale rate of government bonds owned by the Bank of Japan declined. Even under such a situation, a further lower interest rate policy and the strengthening of control of the government bond market were facilitated in order to promote the selling of a larger amount of government bonds.

## 2 Further Absorption of Government Bonds at the Outbreak of the Sino-Japanese War

After the February 26 Incident, *Genro* (senior statesman) Kinmochi Saionji recommended Koki Hirota, the former minister of foreign affairs, to the Emperor, and an Imperial order was issued to Hirota to form a new Cabinet. Eiichi Baba who assumed the post of finance

minister declared the withdrawal of the policy to gradually decrease public bonds promoted by the former finance minister, Takahashi, on March 9, 1936, by saying that “because we are in a situation where we must expect a further increase in national expenditures, it would be totally justified to disburse a part of the expenditures from public bonds; I don’t think that the issue of public bonds is now nearing a stalemate.

### (3) Emergence of 3.5-percent interest-bearing treasury bonds

Under the trend towards an expanding economy and increasing prices, the official discount rate was reduced to 3.285 percent (a daily interest rate of 9 *rin*) in April 1936. Because the 5-percent interest-bearing treasury bonds issued on the market in 1925 were scheduled to reach maturity one after another, Finance Minister Baba refinanced these bonds in May 1936 by 3.5-percent interest-bearing treasury bonds underwritten by the Bank of Japan. Hosaku Hirose, who was the director-general of the Financial Bureau of the Ministry of Finance at the time, noted that “such refinancing is something that cannot be easily implemented under normal conditions; although the Bank of Japan was somewhat reluctant at the beginning, it agreed on such underwriting.”<sup>15</sup>

In such a way, 5-percent interest-bearing treasury bonds worth 2.1 billion yen were refinanced by 3.5-percent interest-bearing treasury bonds during the period from May to September 1936, and yearly interest expenses were reduced by 30 million yen. While the maturity of 1 3.5-percent interest-bearing treasury bonds issued in May 1936 was 12 years, this maturity was gradually prolonged. From December 1936 to

December 1945, bonds with a maturity of 17 years were issued.

What is notable is that the following operation was implemented prior to refinancing to bonds with a lower interest rate. While the issue price (the Bank of Japan underwriting price = market selling price) of 4-percent interest-bearing treasury bonds issued starting in September 1933 was 98.5 yen, this price was increased to 99.25 yen for bonds issued on March 19, 1936, and the maturity was reduced from 27 years to 20 years; 310 million yen of these bonds were issued. According to *Showa zaisei shi* (Financial History of Showa), this operation is seen as a sign of refinancing to bonds with a lower interest rate and brought about a rise in the prices of government bonds and an increase in the amount of government bonds sold by the Bank of Japan.<sup>12</sup>

Furthermore, during the period from November 1936 to September 1937, government bonds were purchased from the market with government funds such as those of the Treasury Deposit Bureau and postal life insurance, and the prices of government bonds were directed towards recovery.

Partly because people saw such a favorable turn, a warning and a prudent attitude against the increased issue of government bonds apparently started to disappear. Kamekichi Takahashi went as far as saying that in today's age, it is meaningless to have a concern over the liquidity of government bonds that is based on uneasiness regarding the credibility of government bonds."

## **(2) Outbreak of the Sino-Japanese War and failure in the public offering of government bonds**

On July 7, 1937, the Marco Polo Bridge Incident occurred in a suburb about 20 kilometers southwest of Beijing. While this incident triggered the Sino-Japanese War, it was called the North China Incident at the time. On the assumption of a nonexpansion policy, it was decided to dispatch Korean troops, Kanto troops and troops from the inland.

On July 29, the 71st Diet session approved the expenses for the North China Incident totaling about 100 million yen. On the same day, the law to finance such expenses by the issue of government bonds, "a matter concerning the issue of public bonds to disburse expenses in relation to the North China Incident," was promulgated. In addition, on August 7, the Diet passed an additional budget of about 400 million yen as expenses for the North China Incident. Among a total of over 500 million yen as expenses for the Incident, it was decided to procure 400 million yen from government bonds. Of this amount, 100 million yen was planned to be raised through public offering, rather than underwriting by the Bank of Japan.

It is said that the issue of government bonds through public offering was in response to the request by a government bond underwriting syndicate consisting of 13 banks and 4 trust companies. As the purpose behind

such a request, *Showa zaisei shi* (Financial History of Showa) pointed out that it implicitly connoted the meaning of preventing expansion of the incident by demonstrating a limit to raise funds for war expenses.<sup>12</sup> The syndicates waived commissions and arranged not to sell bonds one year after underwriting. In response, the government accepted such an offer by saying that "in view of the current situation, it is all to the good," and shortened the maturity to 11 years and 2 months.

In August 1937, *Ri* 3.5-percent interest-bearing treasury bonds were issued for public offering. However, the expansion of the incident coupled by concerns over the increased issue of government bonds to finance an additional budget brought about a crash of the stock market, which had led to a tight money market. In light of the circumstances, Finance Minister Okinori Kaya noted at the House of Representatives session on September 6 that "all public bonds to be issued in the future are to be accepted by the Bank of Japan for the time being; we will be sure to first supply funds to the market, then absorb such funds at an appropriate timing." On September 13, he announced "we will adopt a policy that the issue of government bonds for some time in the future is, in principle, predicated on underwriting by the Bank of Japan."

In such a way, the payment of government bonds worth 100 million yen that were publicly offered was postponed to September 15 and October 15, and the public offering of government bonds was discontinued after this single offer. This failure in the public offering of government bonds shows how the issue of government bonds through underwriting by the Bank of Japan was convenient for the government. While the public offering of government bonds was resumed immediately after Toyotaro Yuki took office as the governor of the Bank of Japan, why wasn't an attempt made for a public offering of government bonds before that time?

## **(3) Establishment of temporary war expenditure special account**

Early in August 1937, the battle was expanded to Shanghai and Nanking, and the North China Incident was renamed the China Incident at the ministerial meeting on September 2. At the 72nd Diet session convened on September 4, expenditures for the incident were separated from the general account, and a temporary war expenditure special account was established by regarding the period until the end of the incident as one fiscal year. This measure followed the precedents of the Sino-Japanese War, Russo-Japanese War and European War (World War I) in which Japan declared war. The establishment of the special account clearly shifted Japan's finance from quasi-wartime finance to wartime finance.

The temporary war expenditure special account represented a budget for several years by regarding the period until the end of a war as one fiscal year. In addition, it

was a rough budget consisting of one title (temporary war expenditures) and three items (army temporary war expenditures, navy temporary war expenditures and a reserve). Accordingly, this budget fell outside the control of the Diet. Examples include misappropriation of expenditures and the conclusion of out-of-budget contracts.

While this budget began on a scale of about 2.5 billion yen, it continued to increase rapidly, and reached 86.1 billion yen in fiscal 1944. The total disbursement amount was 155.4 billion yen, of which 97.6 billion yen was directly financed by temporary war expenditure public bonds. Temporary war expenditure public bonds accounted for 78 percent of all government bonds issued from fiscal 1937 to fiscal 1945.<sup>11</sup> Because a huge amount was transferred from the general account to the temporary war expenditure special account each year, almost all government bonds were issued for the purpose of financing war expenditures if such transfers are included.

### 3 Reduction of Interest Rates for Loans Using Government Bonds as Collateral

When it was decided to further increase the issue amount of government bonds at the outbreak of the Sino-Japanese War (China Incident), measures to absorb government bonds were further strengthened. On July 15, 1937, immediately after the Marco Polo Bridge Incident, the daily interest rate for loans using government bonds as collateral required by the Bank of Japan that was higher by 1 *rin* per 100 yen than the official discount rate in the past was reduced to a daily interest rate of 9 *rin* per 100 yen, which was the same level as the official discount rate.

Because 3.5-percent interest-bearing government bonds generated a daily interest rate of about 1 *sen* (10 *rin*) per 100 yen, banks that borrowed the funds from the Bank of Japan by using government bonds as collateral could secure a rate spread of about 1 *rin* per 100 yen, while they kept owning a large amount of government bonds. Therefore, it had become more advantageous for banks to borrow the funds from the Bank of Japan by using government bonds as collateral than selling government bonds on the market. This meant that banks could acquire the reserve on hand while keeping the government bonds they possessed.

In order to support the cash management of commercial banks, the Bank of Japan had been purchasing government bonds under repurchase agreements starting in October 1935. As an expansionary measure of this operation, the Bank of Japan decided to purchase 3.5-percent interest-bearing government bonds without repurchase agreements from August 1937 if commercial banks (trading banks, trust companies) desired to sell such government bonds. According to *Showa zai-sei shi* (Financial History of Showa), in April 1940,

Governor Yuki of the Bank of Japan established a policy of recommending that banks own government bonds worth one-fourth of the total deposit amount. This policy also included the purchase of government bonds by the Bank of Japan with almost no conditions if a bank had to dispose of government bonds.<sup>12</sup>

In this way, government bonds had become convenient assets that could be converted into cash at any time without the need to sell them on the market. The incentive for banks to own government bonds had been rapidly increased. In September 1941, the “Outline of the Fund Control Plan for Fiscal 1941” was decided at a ministerial meeting. This plan established the goal that government bonds be absorbed for each business type of financial institution in terms of rate to the increased deposit amount.

Backed by these measures, the resale rate of government bonds from the Bank of Japan to the market continued to be at a high, stable rate. Superficially, the absorption of government bonds was extremely smooth. Nevertheless, the amount of government bonds held by the Bank of Japan increased from 1.1 billion yen at the end of 1937 to 5.0 billion yen at the end of 1941 and 9.5 billion yen at the end of 1944. The amount of government bonds owned by banks throughout the country rapidly increased from 4.0 billion yen at the end of 1937 to 12.9 billion yen at the end of 1941 and 33.0 billion yen at the end of 1944; the ratio to deposits also increased from 25.5 percent at the end of 1937 to 34.1 percent at the end of 1941 and 42.3 percent at the end of 1944. Because government bonds owned by these banks could be converted into high-powered money at any time, the structure of accelerating inflation was incorporated into this scheme.

### 4 Promoting the Sales of Government Bonds to Individuals

In addition, in order to avoid the aggravation of inflation, efforts were made to expand the sales of government bonds to individuals. On November 16, 1937, the selling of government bonds was started at post office counters. The government bonds sold at post offices were 3.5-percent interest-bearing government bonds with 17 years remaining before reaching maturity (*Ru*) and were the same as those underwritten by the Bank of Japan.

In offering these bonds, Finance Minister Kaya noted under the title of “Wartime Finance and Cooperation by the People” that “if you buy these government bonds, such money will serve as war expenditures to provide small arms, machine guns, cannons, airplanes, bullets, etc., to our loyal and brave soldiers dispatched to North China and Manchuria; please purchase these government bonds without delay.”<sup>12</sup>

In April 1938, sales locations were also established at public organizations, companies and stores. In

December of the same year, the government requested eight securities underwriting companies including Nomura Securities to sell government bonds through their sales networks. In June 1943, the government bond savings system from which withdrawals were not permitted other than for the purchase of government bonds was introduced, and the savings amount was allocated to each individual through a neighborhood association. During this period, the Treasury Deposit Bureau that used postal savings as the fund source accepted more than 30 percent of government bonds newly issued from the outbreak to the end of the Sino-Japanese War.

Under such strengthened measures for the absorption of government bonds, the issue of a huge amount of government bonds continued. In view of such a situation, Kamekichi Takahashi expressed an extremely optimistic opinion in April 1939 that “suppose we make up for the deficit of 10 billion yen in the coming 20 years, the necessary amount for principal and interest is 700 or 800 million yen yearly. If the national income is newly increased by such an amount, the deficit of our national economy arising from the incident can be sufficiently covered; it would be safe to say that the increase in national income to this extent is not necessarily a difficult matter for Japan after the establishment of the East Asia block.”<sup>12</sup>

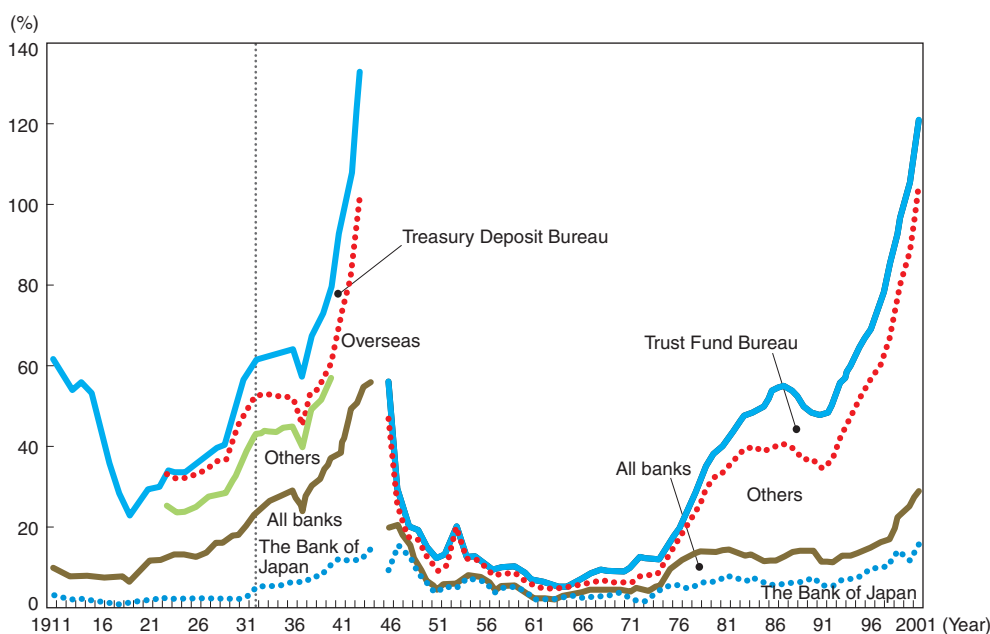
In the trend towards the escalation of the war, Finance Minister Kaya answered at the 84th Diet session in January 1944 that “I think the greater the

amount of government bonds issued, the higher the possibility of winning the war. A state in which government bonds cannot sufficiently be issued, i.e., weapons and ammunition cannot sufficiently be procured, represents a tendency towards losing the war. (Omitted.) The question boils down to winning or losing the war. (Omitted.) At present, the more public bonds that are issued, the more certain the redemption.”<sup>12</sup>

In this way, the outstanding long-term government bonds that amounted to about 10 billion yen at the end of fiscal 1936 increased to 107.6 billion yen at the end of fiscal 1944. By adding short-term securities and loans to this amount, the outstanding debts were 11.3 billion yen at the end of fiscal 1936 and 152.0 billion yen at the end of fiscal 1944. The ratio to GDP increased from 63.5 percent in 1936 to 105.1 percent in 1942, 133.4 percent in 1943 and 204 percent in 1944. Figure 6 is an overview of these government debts. As the national debt increased, debts of the Bank of Japan, commercial banks and the Treasury Deposit Bureau also increased substantially.

After World War II, the Bank of Japan continued to underwrite government bonds as funds to provide allowances to demobilized soldiers. In the budget for fiscal 1946, the dependency on government bonds was 37.4 percent; many of these were underwritten by the Bank of Japan. In 1947, the Public Finance Law was enacted that prohibited the issue of deficit-covering bonds and the underwriting of government bonds by the Bank of Japan in reconsideration of the experience

**Figure 6. Government Debts (Ratio to GDP)**



Notes: (1) Outstanding government debts include loans from the special account and short-term government securities in addition to government bonds. (2) All banks before the war include ordinary banks, saving banks and special banks. (3) The vertical line indicates November 1932 when the underwriting of government bonds by the Bank of Japan began. (4) The overseas total number for 1923 – 1940 is based on the estimate by Shozaburo Fujino and others. Sources: *Meiji iko honpo shuyo keizai tokei* (The Key Economic Statistics of Japan in and after Meiji), the Statistics Bureau, the Bank of Japan, 1966; *Keizai tokei nenpo* (Annual Report of Economic Statistics) for each fiscal year, the Bank of Japan; *Financial and Economic Statistics Monthly* for each fiscal year, the Research and Statistics Department, the Bank of Japan; Kazushi Okawa, Nobukiyo Takamatsu, Yuzo Yamamoto, *Choki keizai tokei 1: kokumin shotoku* (Long-Term Economic Statistics 1: National Income), Toyo Keizai, 1974; Shozaburo Fujino, Juro Teranishi, *Nihon kin'yu no suryo bunseki* (Quantitative Analysis of Japanese Finance), Toyo Keizai, 2000.

in and after 1932. However, until the implementation of Dodge's Line in 1949, the Bank of Japan accepted reconstruction finance corporation bonds, which accelerated post-war inflation.

## IV Warning from International Financial Market

### 1 Did Fisher Effect Emerge?

Although the issue of government bonds continued to increase overwhelmingly, the price of government bonds followed an extremely stable path. In December 1931, when Korekiyo Takahashi took office as the finance minister, the price of domestic government bonds, the first series of 4-percent interest-bearing public bonds (issued in 1910 for redemption in 1969), declined to 73.41 yen against a face value of 100 yen. However, the price recovered with progress in the shift to a managed currency system and after the control on the transfer of funds. The monthly average price reached a level of 99 yen in August 1933 and remained over par starting in April 1936 after the February 26 Incident.

Despite such factors as the rapid decline of the rate of yen to dollars resulting from the abolition of the gold standard, an ongoing shift of the year-on-year rate of the consumer price to a positive number and the start of the underwriting of government bonds by the Bank of Japan, the interest rate of Japanese government bonds did not increase.

Does this mean that major political changes such as the abolition of the gold standard and the underwriting of government bonds by the Bank of Japan prevented the generation of the Fisher Effect, in which an increase in the rate of expected inflation brings about an increase in the nominal interest rate?

Yoichi Takahashi pointed out that "there is a criticism that when inflationary expectations are generated, the nominal interest rate increases. However, in order for the nominal interest rate to increase by a rate corresponding to the increase in the expected inflation rate under the Fisher equation, the national economy must remain at full employment. (Omitted.) This requirement is supported by the verification study that indicated that the Fisher Effect becomes asymmetric in an economic recovery period and in a recession period. Furthermore, in the Great Depression of the 1930s, an increase in the nominal interest rate was not seen, as indicated by the history of the United States and Japan."<sup>32</sup>

However, it was not the situation that the state of underemployment continued after the end of 1931 when the policy was changed and after the end of 1932. The economy that bottomed out in 1931 turned to a rapid recovery, recording 4.4 percent growth in 1932 and achieving a high level of growth of 8 – 10 percent in 1933 – 1934 in terms of real economic growth. In

the latter half of 1932, wholesale prices increased by 60 percent in terms of the annual rate.

Nevertheless, the interest rate of government bonds did not increase. The conditions behind the lack of an increase include: the isolation of the domestic market from the international financial market by the Capital Flight Prevention Law enacted in July 1932 and the Foreign Exchange Control Law enacted in March 1933; the adoption of the official government bond book value system in July 1932 to eliminate risks of fluctuating government bond prices; and the supply of liquidity to banks that own government bonds (preferential treatment for loans using government bonds as collateral).

Even if the hypothesis is adopted that some time is required for the Fisher Effect to emerge due to a deflation gap, it is difficult to explain why the interest rate of long-term government bonds remained at 3.5 percent from the summer of 1935 when it became difficult for the Bank of Japan to sell government bonds until defeat in World War II. It should be considered that financial isolation and control of the government bond market restrained the generation of the Fisher Effect.

However, Masazumi Wakatabe pointed out that the Capital Flight Prevention Law and the Foreign Exchange Control Law were not effective. The linkage between the long-term interest rate of Japan and that of the United States increased together with that of Germany and France, and the internal and foreign interest rates fluctuated in accordance with the fundamentals of the economy in each country. This suggests that the control of fund transfers was not really effective."<sup>37</sup>

*Showa kyoko no kenkyu* (Research on the Showa Depression) pointed out that "fluctuations themselves in the long-term interest rate of each country including Japan increased linkages since 1933 more than those before 1933. This strongly suggests that it was not the case that the long-term interest rate remained low as a result of artificial operations by the control of capital outflow."<sup>6</sup>

The Capital Flight Prevention Law was intended to prohibit the promotion of overseas investment accompanying a decline of the yen rate. Accordingly, this law could not actually prevent the outflow of funds overseas by using trade exchange, and the yen rate continued to drop to its lowest price of 100 yen = 19.875 dollars in November 1932.

However, overseas securities investment was strictly controlled, and it is assumed that internal and foreign interest rate arbitrage trading (investment aimed at rate spread by using the differential of interest rates among markets) became impossible. Actually, *Nomura shoken kabushiki gaisha 40-nen shi* (The 40-Year History of Nomura Securities) indicated that "the enforcement of the Capital Flight Prevention Law not only prohibited the imports of securities in foreign currencies that had been conducted in New York in the past, but also made

it impossible to trade bonds in foreign currencies in New York under the name of a company established pursuant to the law of Japan.”<sup>31</sup>

In addition, beginning in May 1933, the Foreign Exchange Control Law was enforced, and the transfer of funds was totally controlled. The representative office of Nomura Securities in New York was also closed at the end of 1933.

In light of these circumstances, it can be said that the fact that the abolition of the gold standard and the underwriting of government bonds by the Bank of Japan did not generate the Fisher Effect is not attributable to the existence of a deflation gap, but was derived from the implementation of financial isolation by the control of fund transfers and the adoption of the policy to maintain the government bond price at the same level within the country.

*Showa kyoko no kenkyu* (Research on the Showa Depression) measured that the linkage between the interest rate of the United States and that of each country increased in particular after 1933.<sup>6</sup> This was due to the fact that the interest rates of government bonds in Japan and Germany were placed under strict control so that they would follow a stable path at low levels. Specifically, the Foreign Exchange Control Law was enforced in Japan in May 1933, and total control of exchange transactions started in September 1934 in Germany by Finance Minister Hjalmar Schacht. The interest rates of government bonds in Japan and Germany merely seemed to strengthen their linkage with those of the United Kingdom and the United States by government control.

After the abolition of the gold standard, the interest rate of UK government bonds remained stable by exchange equalization operations and market intervention by the Bank of England. While the buying operation of government bonds by the Federal Reserve Bank was also conducted in the United States, the interest rate of long-term government bonds followed a stable path until the Korean War through restriction of the expected inflation rate by reserve ratio operations, etc.

In contrast, the interest rates of Japanese government bonds discussed in this paper and those of German government bonds in the Nazi era simply maintained a declining tone by control under the closed economy. The thought that because linkages were increased among the interest rates of government bonds in major countries, the control of capital flight did not function in Japan must be considered a misinterpretation of cause and effect.

## 2 Financial Discipline Became Lax by Financial Isolation

The real interest rates of Japanese government bonds can be seen in the international financial market. What

fluctuated in accordance with the fundamentals of economy in each country was not the interest rates of government bonds within a country, as pointed out by Wakatabe,<sup>37</sup> but the interest rates of government bonds of each country on the London capital market.

### (1) Japanese government bonds descend to junk bonds

While the interest rate of the first series of 4-percent interest-bearing public bonds with redemption in 1969 followed a declining trend, the interest rate of pound-denominated Japanese government bonds with the same coupon and redemption in 1953 (the first series of 4-percent interest-bearing pound-denominated public bonds) increased after the Manchurian Incident. The interest rate differential between these bonds largely expanded as shown in Figure 7.

The interest rate of 4-percent interest-bearing pound-denominated public bonds that was 6.18 percent in January 1930 when the gold embargo was lifted dropped to 5.52 percent in April 1931. However, it began to rise in September 1931 and reached 8.25 percent when the re-embargo of gold exports was imposed. It recorded 9.26 percent in July 1932 when the Capital Flight Prevention Law was enforced, increased to 9.69 percent in November 1932 when the underwriting of government bonds by the Bank of Japan started, and exceeded 10 percent in February 1933. Subsequently, with a decline in the interest rate of consols in the United Kingdom, the interest rate of 4-percent interest-bearing pound-denominated public bonds remained stable at around 8 percent.

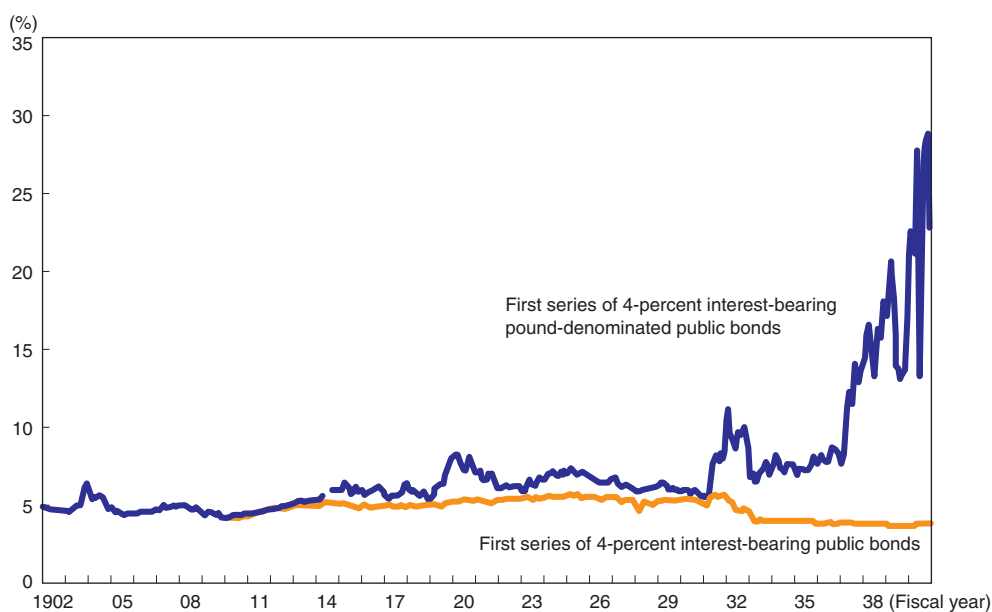
However, in July 1937, with the outbreak of the Sino-Japanese War, the interest rate of 4-percent interest-bearing pound-denominated public bonds again exceeded 10 percent. Since then, the rate continued to increase and exceeded 20 percent in September 1939 (Germany's invasion of Poland) when the European War II broke out. In September 1940, when the triple alliance of Japan, Germany and Italy was formed, it was 21 percent. While the price of the first 4-percent interest-bearing public bonds remained over par on the Tokyo market in September, the price of public bonds with the same coupon was only 25 percent of face value on the London market. As if Japan's defeat and subsequent inflation were anticipated on the London market, Japanese government bonds descended to junk bonds (speculative grade bonds).

A sharp contrast between a decline in the interest rate of domestic government bonds and an increase in the interest rate of pound-denominated government bonds, as indicated in Figure 7, also emerged in Nazi Germany in the very same manner.

### (2) Impact of overseas investment control

This section examines the situation of interest rate arbitrage based on the first series of 4-percent interest-bearing

**Figure 7. Changes in Interest Rates of 4-Percent Interest-Bearing Pound-Denominated Public Bonds and Domestic Government Bonds**



Notes: (1) Interest rates of the first series of 4-percent interest-bearing public bonds (issued in 1910 with redemption in 1969) are those on the Tokyo market; interest rates of the first series of 4-percent interest-bearing pound-denominated public bonds (issued in 1899 with redemption in 1953) are those on the London market. However, data for pound-denominated public bonds are lacking for August – December 1914. (2) The yield was calculated by using the monthly average price and the Nomura financial function; semiannual compound interest yield.

Sources: *Meiji Taisho zaisei shi* (Financial History of Meiji and Taisho), edited by the Ministry of Finance, Volume 12, Keizai Orai Sha, 1956; *Kokusai Tokei* (Government Bond Statistics) for fiscal 1906 – fiscal 1908; *Okura sho nenpo* (Ministry of Finance Annual Report), the 38th – 66th annual reports.

pound-denominated public bonds. These pound-denominated Japanese government bonds were also traded on the Tokyo market. The price of the public bonds with a face value of 100 pounds was recorded sporadically beginning in April 1921 and on a continuous basis from April 1924 to March 1941. Until September 1931, in the period during which the Manchurian Incident occurred and pounds were separated from the gold standard, as shown in Figure 8, the price of the first series of 4-percent interest-bearing pound-denominated public bonds on the Tokyo market remained at almost the same level as they did on the London market after conversion using the yen-pound rate at the time.

This circumstance is considered to be attributable to the functioning of interest rate arbitrage backed by confidence in the policy to maintain the yen rate at the same level despite fluctuations in the yen-pound rate during the period that gold exports were prohibited (September 1917 to December 1929).

Actually, Japanese investors actively invested in Japanese government bonds in foreign currencies such as pound-denominated bonds by examining the differential between internal and foreign interest rates. For example, they actively made overseas investments during the period when interest was increasing in major European countries after World War I. Subsequently, in early 1921 when Japanese finance became tight, bonds in foreign currencies that they had previously purchased were sold, chiefly in the United States. When the differential between internal and foreign interest

rates increased in 1926 through progress in monetary relaxation, they again imported Japanese government bonds in foreign currencies to the Tokyo market.

While overseas securities investment was temporarily restrained in anticipation of a stable yen after the lifting of the gold embargo in January 1930, such investment again became active around the end of 1931. In addition to a decline in the price of the pound-denominated public bonds in London due to the Manchurian Incident, yen temporarily rose because of the abolition of the gold standard involving pounds. Due to these factors, the price of pound-denominated government bonds was lowered substantially as compared to the price on the Tokyo market. In addition, because the United Kingdom abolished the gold standard, anticipation grew that Japan would eventually re-prohibit gold exports, and trades selling yen and buying foreign currencies became active and investments in foreign bonds flourished.

Through these arbitrage moves, in January 1932, the price of the first series of 4-percent interest-bearing pound-denominated public bonds on the Tokyo market reached almost the same level as the price in London after conversion to yen.

Under the circumstances of the rapidly falling yen by the re-embargo of gold exports, overseas securities investments became active, which further accelerated the rapid weakening of the yen. To deal with this situation, the government decided to submit the Capital Flight Prevention Law to the 62nd Diet session in May 1932. According to *Showa zaisei shi* (Financial History

of Showa), this decision conversely increased the demand for bonds in foreign currencies and brought about the reverse effect of accelerating overseas investment.<sup>13</sup> The price of the first series of 4-percent interest-bearing pound-denominated public bonds with a face value of 100 pounds increased from 42.25 pounds in June 1932 to 51.375 pounds in July on the London market, and increased from 600 yen in May to 700 yen in July on the Tokyo market.

The Capital Flight Prevention Law was put in force on July 1, 1932, and purchases of bonds in foreign currencies were strictly controlled. A stamp was affixed to securities in foreign currencies that existed within the country at the time (also securities subsequently imported with permission), and only trades of securities with a stamp were permitted within the country. In addition, in April 1933, the Foreign Exchange Control Law was enacted to strengthen exchange control.

In this way, interest rate arbitrage no longer functioned. Although the price of the 4-percent interest-bearing pound-denominated public bonds on the Tokyo market had temporarily slumped as compared to that on the London market, Japanese government bonds in foreign currencies imported to the Tokyo market were gradually recognized as domestic government bonds and the price of such bonds rapidly increased towards their face value. As the rate was fixed at 1 yen = 1 shilling 2 pence in October 20, 1934, the 4-percent

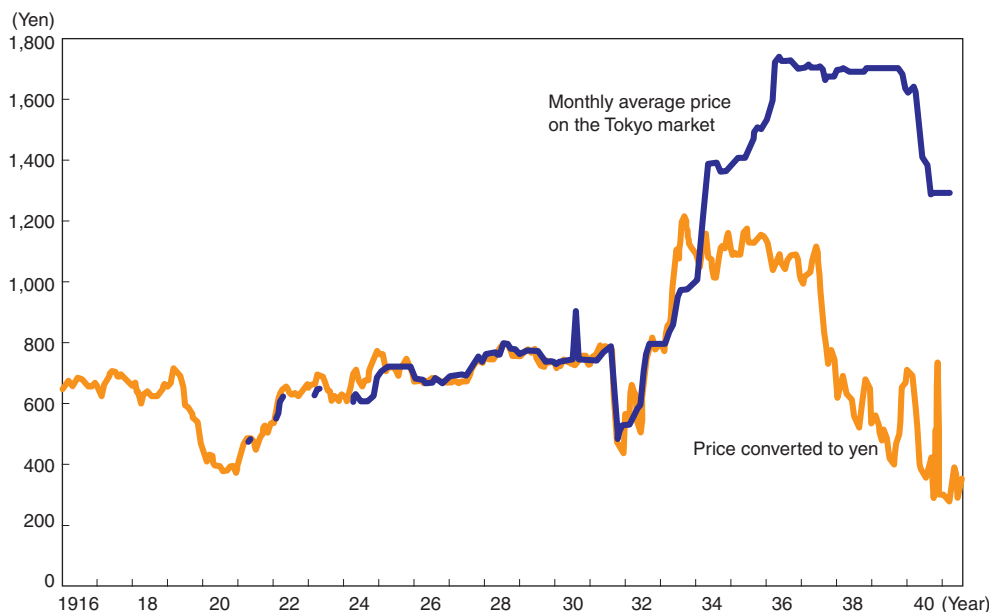
interest-bearing pound-denominated public bonds with a face value of 100 pounds started to be regarded as bonds with a face value of 1,714 yen. As is shown in Figure 8, the price of these bonds rose rapidly.

In contrast, the price of the 4-percent interest-bearing pound-denominated public bonds on the London market hovered around the level of 60 percent of face value after the enforcement of the Foreign Exchange Control Law. However, the price sharply declined after July 1937 when the Sino-Japanese War began.

Although it became impossible to pay the principal and interest of Japanese government bonds overseas as a result of the outbreak of the Pacific War (December 1941), payments were made to owners living in Japan if coupons existed within the country at the specified exchange rate of 1 dollar = 2 yen 25 *sen* and 1 pound = 16 yen 84 *sen*. Subsequently, on September 15, 1943, Japanese government bonds in foreign currencies owned by people living in Japan were refinanced by yen-denominated Japanese government bonds. This decision is considered to be attributable to the increase in interest payments as the yen rate substantially declined as compared to that at the time these bonds were issued.

With respect to the first series of 4-percent interest-bearing pound-denominated public bonds, Japanese investors owned 2.47 million pounds at the time the Pacific War began from among a total of 10 million

**Figure 8. Prices in Yen of the First Series of 4-Percent Interest-Bearing Pound-Denominated Public Bonds (Face Value of 100 Pounds)**



Notes: (1) The first series of 4-percent interest-bearing pound-denominated public bonds was issued on July 1, 1899, in London with an issue amount of 10 million pounds (97.63 million yen); the issue price was 90 pounds for a face value of 100 pounds; interest payments in June and December; redemption in 1953. (2) The monthly average price of this public bond on the London market was converted to yen by using the yen-pound rate; however, for the period of October 1934 – September 1939, the fixed rate of 1 yen = 1 shilling 2 pence (1 pound = 17.14 yen) was used. (3) Although the price on the Tokyo market in August 1930 is indicated as 912 yen on Page 140 of the fiscal 1930 version of *Kokusai tokei nenpo* (Annual Report of Government Bond Statistics), this is considered to be a typographical error.

Sources: Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics 1914 – 1941*, Federal Reserve System, 1943; *Meiji Taisho zaisei shi* (Financial History of Meiji and Taisho), edited by the Ministry of Finance, Volume 12, Keizai Orai Sha, 1956; *Kokusai Tokei* (Government Bond Statistics) for fiscal 1906 – fiscal 1908; *Okura sho nenpo* (Ministry of Finance Annual Report), the 38th – 66th annual reports; *Kokusai tokei nenpo* (Annual Report of Government Bond Statistics) for each fiscal year, edited by the Financial Bureau of the Ministry of Finance, the Ministry of Finance.

pounds issued in 1899. In September 1943, these bonds were converted to 3.5-percent interest-bearing treasury bonds worth 27.08 million yen with an issue price of 98 yen and maturity of 18 years.

According to *Showa zaisei shi* (Financial History of Showa), the conversion price was 95 percent of the average domestic market price for 1941 – 1942. It was 1,235 yen in the case of the first series of 4-percent interest-bearing pound-denominated public bonds. If the owners were Japanese citizens and securities in foreign currencies existed overseas, the 5-year average market price from 1937 to 1941 was used, which was converted to yen by using the exchange rate each time. The price of such public bonds in foreign currencies was 755.5 yen.<sup>12</sup>

### 3 Disregarded Warnings from the International Financial Market

In the past, after the end of the Russo-Japanese War, the international financial market had required risk premiums for Japanese government bonds. Although Japan won the war, confidence in Japanese government bonds was low due to Japan's vast amount of accumulated foreign debt after the war, coupled with a trade deficit that had become common at the time. For these reasons, enhancing the credibility of Japanese government bonds was made a major political issue, and the government strengthened its discipline to promote sustainable financial management. In 1906, the National Debt Consolidation Fund was established for ensuring the redemption of government bonds. With a shift to an austerity policy from the fiscal 1908 budget, outstanding government bonds were reduced during the period from 1911 through 1916.

However, the situation after the Manchurian Incident was completely different. While large risk premiums were required of Japanese government bonds issued in foreign currencies, Japan isolated the domestic market from the international financial market by regulating capital outflow, and strengthened its control. A large amount of Japanese government bonds was then absorbed in the controlled domestic market. Accordingly, the increase in the interest rates of bonds in foreign currencies did not serve as an incentive to restore fiscal discipline.

As pointed out by Masato Shizume, the mechanism of fiscal discipline that worked under the gold standard was lost with the abolition of the gold standard.<sup>21</sup> The underwriting of government bonds by the Bank of Japan that was once implemented entailed a variety of adverse outcomes including the relaxation of fiscal discipline, the promotion of the procurement of war expenditures, the increased issue of government bonds on a limitless basis, the expansion of the war and post-war hyperinflation.

*Showa kyoko no kenkyu* (Research on the Showa Depression) pointed out “there were two factors behind

successfully getting away from the Showa Depression under Takahashi finance: the abolition of the gold standard and the underwriting of government bonds by the Bank of Japan.” It also indicated that the abolition of the gold standard was a necessary condition but not a sufficient condition to change people's concerns over deflation, and that monetary relaxation by the underwriting of a large amount of government bonds by the Bank of Japan substantially increased the expected inflation rate. In light of this situation, it suggests to Japan early in the 21st century that an inflation target should be established and the buying of long-term government bonds should be implemented on a limitless basis.<sup>6</sup>

As explained in this paper, the abolition of the gold standard and the low interest policy served as an impetus to break out of the Showa Depression. In this respect, the indication of *Showa kyoko no kenkyu* (Research on the Showa Depression) appears correct. However, the underwriting of government bonds by the Bank of Japan that was once implemented made it impossible to even find an exit from such practice, and it is not too much to say that it brought about the expansion of the war by serving as a convenient source of funds for the military.

*Showa kyoko no kenkyu* (Research on the Showa Depression) developed its argument on the assumption that the exit from the underwriting of government bonds by the Bank of Japan was blocked by the military. However, if expansion of the war were considered the result of underwriting by the Bank of Japan, it would not be possible to say that the success in getting away from the Showa Depression was brought about by the underwriting of government bonds by the Bank of Japan. Moreover, this book develops an argument that totally ignores the trend of interest rates of the Japanese government bonds in the international financial market. I wonder if it is too much to say that such an argument is no different from that of the military authorities at the time.

The interest rates of Japanese government bonds at the beginning of the 21st century have remained far lower than those during the period starting with the abolition of the gold standard to the end of World War II, as discussed in this paper. Of course, such low interest rates are not attributable to the measures to support the price of government bonds under control of the government. Almost all government bonds are now issued by public offering and bidding, and the freedom in international capital movement is completely secured. Current low interest rates reflect that the expected inflation rate of the Japanese economy and the long-term growth rate in the future are both low.

However, such low interest rates contribute to obscuring the recognition that government bonds are being issued on an accelerated basis. The fact is that, after the Manchurian Incident, the price of government bonds

remained high and government bonds were smoothly absorbed facilitated expansion of government spending centered on the military expenses. In 1942, when the Battle of Midway occurred, Japan's outstanding debt (the total amount of government bonds, short-term government securities and borrowings) exceeded its economic scale (GDP). In the 1990s, large-scale measures to stimulate the economy were taken repeatedly to deal with an accelerating decline in the interest rate with the background of a decrease in the expected inflation rate. As a result of these measures, Japan's outstanding debt exceeded its economic scale in 2000 and exceeded that recorded in 1943 by 1.33 times in terms of the ratio of such debt to GDP in 2002. In comparing economic scale, currently accumulated government bonds are much larger than were those in 1943 when Japan withdrew its troops from Guadalcanal and conscripted students. Despite such a situation, that the interest rates of long-term government bonds have remained extremely low delays efforts to shift to sound finance.

In the 21st century, the international financial market continues to require risk premiums for Japanese government bonds. For example, as of October 2002, the interest rate of Japanese government bonds with redemption in 2010 was 0.15 percent higher than that of yen-denominated Italian government bonds with the same maturity. As demonstrated by the history of Japanese government bonds after the Manchurian Incident, Japan can no longer ignore warnings from the market. Moreover, even if the interest rates of government bonds are increased in the future, separation of the overseas market and the domestic market must not be implemented by imposing controls on capital outflow on the pretext of promoting the absorption of government bonds.

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**Toshiki TOMITA** is a visiting research fellow of NRI, a professor of the Law Faculty at Chuo University and Doctor of Economics, Kyoto University. His specialties include economics policy.

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Inquiries to: Corporate Communications Department  
Nomura Research Institute, Ltd.  
E-mail: [nri-papers@nri.co.jp](mailto:nri-papers@nri.co.jp)  
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