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The Japanese Economy during the Interwar Period: Instability in the Financial System and the Impact of the World Depression

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The Japanese economy during the interwar period faced chronic crises. Among them, the Showa Financial Crisis of 1927 and the Showa Depression of 1930-31 marked turning points. The Showa Financial Crisis of 1927 was the consequence of persistent financial instability because of the incomplete restructuring in the business sector and postponements in the disposal of bad loans by financial institutions. The crisis brought reforms in the financial sector through large-scale injections of public funds and the amalgamation of banks. The Showa Depression of 1930-31 was caused by the Great Depression, a worldwide economic collapse, which had been intensified in Japan by the return to the Gold Standard at the old parity. Japan escaped from the Great Depression earlier than most other countries through a series of macroeconomic stimulus measures initiated by Korekiyo Takahashi, a veteran Finance Minister who resumed office in December 1931. Takahashi instituted comprehensive macroeconomic policy measures, including exchange rate, fiscal, and monetary adjustments. At the same time, the Gold Standard, which had been governing Japan's fiscal policy, collapsed in the wake of the British departure from it in September 1931. Then, Japan introduced a mechanism by which the government could receive easy credit from the central bank without establishing other institutional measures to govern its fiscal policy. This course of events resulted in an eventual loss of fiscal discipline.

I. Introduction

The Japanese economy faced chronic crises during the interwar period. Among the crises, the Showa Financial Crisis of 1927 and the Showa Depression of 1930-31 marked turning points. The Showa Financial Crisis of 1927 was the consequence of persistent financial instability because of incomplete restructuring in the business sector and postponements in the disposal of bad loans by financial institutions. The Showa Depression of 1930-31 was caused by the Great Depression, a worldwide economic collapse which had been intensified in Japan by the return to the Gold Standard at the old parity in January 1930.

[Chart 1] Economic Growth and Inflation

(Percentage change from previous year)

Year	Real GNP	GNP Deflator	Remarks
1914-19	6.2	13.6	World War I Boom
1920-29	1.8	-1.3	Chronic Recession
1930-31	0.7	-10.3	Showa Depression
1932-36	6.1	1.5	Takahashi Economic Policy
1937-40	5	11.9	Wartime command economy

Source: Ohkawa, Kazushi, Nobukiyo Takamatsu, and Yuzo Yamamoto (1974), *Estimates of Long-Term Economic Statistics of Japan since 1868, 1, National Income.*

We divide the period from the outbreak of the First World War (1914) to that of the Second World War (1939) into five sub-periods (Chart 1). The first sub-period was an economic boom with high rates of growth and inflation, from 1914 to 1919. This was followed by about a decade of dull, mildly deflationary activity (1920-29). In 1930 and 1931, the economy succumbed to the Showa Depression, a two-year bout of severe deflation and economic decline. From 1932 to 1936, the economy recovered under the "Takahashi Economic Policy" (*Takahashi Zaisei*), achieving high growth and modest inflation.[1] Then, from 1937, Japan entered the era of the command economy of the Asia-Pacific War, embarking on several years of high growth and rampant inflation.[2]

This paper gives an overview of the Japanese economy during the interwar period. We focus on the policy responses to the instability of the domestic financial system in the 1920s and to the impact of the Great Depression of the 1930s.

II. Chronic Financial Crises and Policy Responses in the 1920s

The Japanese economy of the 1920s suffered from a retrenchment after the boom of the First World War. For most of the decade, the real economy remained dull, with low economic growth, mild deflation, and an unsettled financial system. Some observers describe the economic condition in Japan during the 1920s as a state of "chronic depression."[3] The Showa Financial Crisis of 1927 marked a turning point for the disposal of bad loans and the restructuring of the banking sector, which eventually resolved the problems with the domestic financial system (See Chart 2 for the chronology).

[Chart 2] Chronology of the Financial Crises of the 1920s

Year	Date	Event
1920	7-Apr	Masuda Bill-Broker Bank fails.
1922	28-Feb	Ishii Corporation fails.
	19-Oct	Nippon Commerce and Industrial Bank in Kyoto suspends operations.
	29-Nov	Nippon Sekizen Bank in Kyoto announces a suspension of operations, a move which triggers bank panic in the Kyoto and Nara regions.
	30-Nov	Kyushu Bank in Kumamoto announces a suspension of operations.
1923	1-Sep	The Great Kanto Earthquake
	27-Sep	The Diet promulgates the imperial emergency ordinance, a legislation to indemnify the losses incurred by the Bank of Japan through the rediscounting of the Earthquake Casualty Bills (ECBs).
1927	26-Jan	New legislation to adjust the ECBs is submitted to the Diet.
	14-Mar	Finance Minister Kataoka misstates the failure of Tokyo Watanabe Bank.
	23-Mar	The Diet approves the new legislation to adjust the ECBs.
	30-Mar	The Banking Act of 1927 is proclaimed (to take effect on January 1, 1928).
	17-Apr	The Privy Council rejects the imperial emergency ordinances for relief of the Bank of Taiwan.
	18-Apr	The Bank of Taiwan suspends operations outside of Taiwan Island.
	21-Apr	The Fifteenth Bank suspends operations.
	22-Apr	The Diet proclaims an imperial emergency ordinance for a 3-week moratorium.
	8-May	The Diet passes and promulgates the Bank of Japan's Special Credit Bill and the Financial Relief Bill for Taiwanese Banks.

Sources: Institute for Monetary and Economic Studies, Bank of Japan [1993], *Nihon Kin'yu Nenpyo* (Chronology of Financial Matters in Japan); *Nippon Ginko Hyakunen-Shi* (Bank of Japan: The First Hundred Years), Vol. 3.

A. Post-War Collapse in 1920

In March 1920, stock prices plunged as investors anticipated a hard-landing for the Japanese economy after the boom of the First World War. In April 1920, Masuda Bill Broker Bank in Osaka failed, triggering a bank run in several regions throughout Japan. The bank had been engaged in the intermediation of interbank transactions, and its customers had included both local banks and large city banks. Then, over the next four months, from April to July 1920, operations were suspended at 21 banks, either permanently or temporarily.[4] The Bank of Japan (BOJ) extended various types of "special loans" to ease tensions within the financial markets in general and stabilize financial markets by relieving specific key industries.[5]

B. Financial Panic of 1922

Ishii Corporation, a lumber company engaged in speculative activities, went bankrupt at the end of February 1922, triggering bank runs in Kochi Prefecture (in southwestern part of Japan) and Kansai region (Osaka, Kyoto and their environs). Then, from October through December 1922, bank runs spread far across the country, from Kyushu (the westernmost part of Japan) through Kanto (Tokyo and its environs in eastern Japan). In 1922, operations were suspended at 15 banks, either permanently or temporarily. The BOJ extended "special loans" to 20 banks from December 1922 to April 1923.

The government tightened regulations on small-sized saving banks by enacting the Saving Bank Act of 1921. Next, it tried to accelerate reforms in the financial system as a whole, including the larger-sized ordinary banks.[6]

C. "Special Loans" after the Great Kanto Earthquake of 1923

The Great Kanto Earthquake in September 1923 hurt the financial system in Japan, damaging the financial assets of banks, as well as their physical capital such as the bank headquarters buildings and branches. Depositors feared bank losses and delays in the repayment of bank loans.

On September 7, the government promulgated an emergency ordinance to impose a moratorium, which allowed for the postponement of payments due from that month onward in the districts affected. As events transpired, the BOJ made special arrangements, including "special loans." Then, on September 27, the government promulgated another emergency ordinance to indemnify the BOJ for any losses incurred in the re-discounting of bills and certain other papers payable in the stricken areas (Earthquake Casualty Bills, or ECBs), to a ceiling of 100 million yen.[7]

Depositors were relieved by these special measures of the government and BOJ. By the time the moratorium was lifted in October 1923, financial turbulence had been curbed. Meanwhile, large portions of the ECBs had yet to be settled. After two postponements of the due date for settlement, the date was finally set for September 30, 1927.

D. The Showa Financial Crisis of 1927

In January 1927, the Wakatsuki Cabinet of the ruling *Kensei-kai* Party took a step to facilitate the final disposition of the bad debts incurred by the Great Kanto Earthquake by submitting legislation to the Diet requiring adjustments of the ECBs. This legislation allowed the government to issue bonds which could be exchanged with the ECBs. On March 14, in the courses of heated debate on the government's measures in the Diet, Finance Minister Naoharu Kataoka falsely declared that the Tokyo Watanabe Bank had failed (the bank had not yet failed at the time of this declaration). This statement set off a surge of financial panic in the regions surrounding the two great metropolises, Tokyo and Osaka. On March 23, the Diet approved the legislation, temporarily calming the depositors' panic.

A nationwide financial panic was sparked when debates in the Diet revealed financial difficulties between the Bank of Taiwan and Suzuki & Co., a big trading house based in Kobe. The Bank of Taiwan had a monopoly in issuing bank notes on Taiwan Island, and close business ties with Suzuki & Co. In response, the Cabinet tried to issue an emergency ordinance authorizing the BOJ to send the Bank of Taiwan relief funds, and indemnifying the BOJ for any losses incurred by this action up to a ceiling of 200 million yen. The Privy Council, the body invested with the authority to approve the emergency ordinance, politicized the Cabinet's plan and rejected it on April 17. The Wakatsuki Cabinet resigned and financial panic spread nationwide.[8]

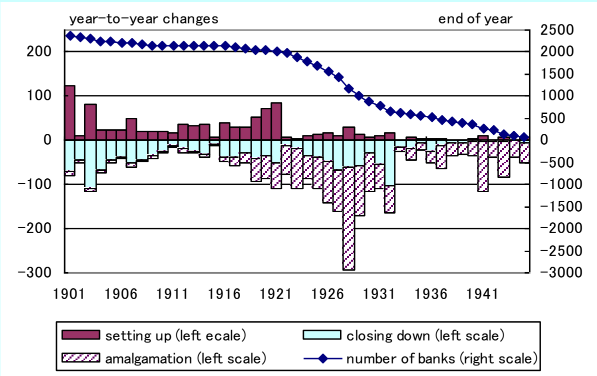
On April 20, 1927, Giichi Tanaka of the opposition *Seiyu-kai* Party took office. Korekiyo Takahashi became Finance Minister for the fourth time, and the government proclaimed an emergency ordinance imposing a three-week moratorium, effective from April 22 to May 12. Next, the Diet convened an extraordinary session to deliberate on two bills. The first was to authorize the BOJ to make special advances under the government guarantee of indemnity against consequent loss, up to a maximum of 500 million yen (the Bank of Japan's Special Credit Bill). The second was to accommodate financial institutions on the Island of Taiwan under a government guarantee of indemnity against the consequent loss, up to a maximum of 200 million yen (the Financial Relief Bill for Taiwanese Banks). These two bills, passed and promulgated on May 8, proved sufficiently reassuring to quell the panic. The moratorium was lifted on May 13.[9]

III. Reforms in the Banking System

A. Banking Act of 1927 and Reforms in the Financial System

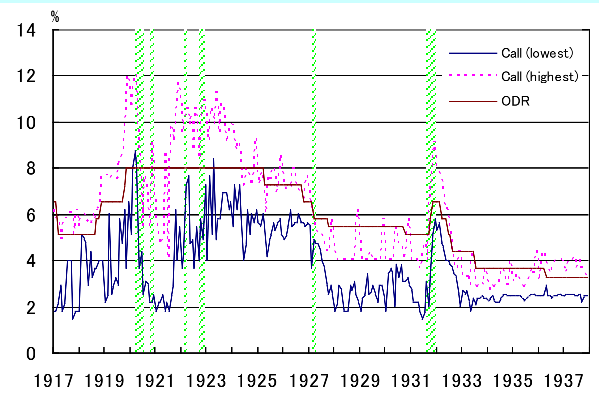
Major progress towards the resolution of the financial crises of the 1920s took place in 1927, when structural reforms in the banking sector gained momentum in

[Chart 3] Number of Banks and Year-to-Year Changes



Source: Goto [1970]

[Chart 4] Tokyo Call Rate and Official Discount Rate of BOJ



Source: Ministry of Finance, *Kin'yu Jiko Sanko-Sho* (Reference Book of Financial Matters), annual editions.
* Shadowing indicates periods of spread financial panics.

step with measures to dispose of the bad loans. The new Banking Act was promulgated on March 30, 1927, in the midst of the Showa Financial Crisis, with plans for effectuation on January 1, 1928. The Act stipulated minimum capital requirements for banks and prohibited banks and bank managers from conducting most non-banking businesses. Under this Act, the authorities reinforced the bank examination and encouraged amalgamation of banks to stabilize the financial system as a whole. The number of banks declined steadily through the 1920s, and the trend accelerated in 1927 with an increase in mergers (Chart 3).[10]

Chart 4 shows developments in the call rates, the referenced interest rates for short-term interbank transactions of funds, and the official discount rate (ODR) of the BOJ. Call rates remained high between the financial panic of 1922 and the Showa Financial Crisis of 1927, reflecting a high risk premium. A number of banks with high risk profiles, such as the Bank of Taiwan, tried to raise funds in the interbank market over that period. Aware of the credit risk of the distressed banks and instability in the financial market in general, lenders required high risk premiums.[11]

Call rates decreased substantially in the spring of 1927, as market participants gained confidence from the new Banking Act, the disposition of the Showa Financial Crisis, and the stabilizing financial markets.

B. Causes and Consequences of the Financial Instability of the 1920s

Many observers argue that the financial instability of the 1920s was fundamentally caused by incomplete restructuring in the business sector and postponement in the disposal of bad loans by financial institutions after the economic boom of the First World War.

The prominent economist Eigo Fukai, then an Executive Director of the BOJ and later the bank's Governor, wrote :

> In summing up the fundamental causes of massive bank failures in 1927, we can conclude that the original sources were the inappropriate business practices during the post-war collapse and the temporary stop-gap measures to fix them. Ultimately, it all came to the inevitable end.[12]

Kamekichi Takahashi, another prominent economist and ex-editor of *Toyo Keizai Shinpo* (the Oriental Economist), wrote:

> The fundamental causes of the Financial Crisis of 1927 were the cumulative mismanagement of cover-ups and halfway measures against earlier flaws dating back to the post-war collapse. These problems were revealed inadvertently during the debate on ECBs, igniting the explosion of the financial crisis.[13]
>
> The unimaginable financial panic induced drastic reforms in the banking system, whether people liked it or not. The panic contributed to many of the reforms that were to follow.[14]

Kamekichi Takahashi also argued that the reforms of the domestic financial system after the Showa Financial Crisis of 1927 helped Japan respond effectively to the Great Depression in the 1930s:

> A number of leading industrial countries suffered from the World Financial Crisis, a financial collapse without precedent, in the third quarter of 1931 (in the case of the United States, the crisis hit in the first quarter of 1933). For many years to follow, the economic activities of these countries were severely disrupted by the financial collapse. Yet Japan remained immune to the financial crisis of the 1930s, enjoying the benefits of the policy changes and the depreciation of the yen… This could be credited to the total restructuring of Japan's banking system in the wake of the Financial Crisis of 1927.[15]

To sum up, Japan faced serious financial difficulties during the 1920s. The government instituted policies on two fronts to surmount these difficulties in the years during and after the Financial Crisis of 1927: the massive injection of public funds by indemnifying against lending losses of the central bank, and structural reforms in the banking sector through the promotion of bank amalgamation and other measures of that sort.

IV. Return to the Gold Standard and the Showa Depression of 1930-31

A. Returning to the Gold Standard

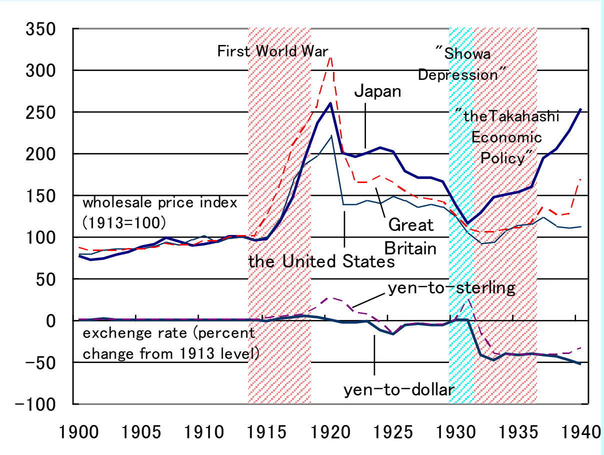
After the First World War, leaders around the world sought to restore the suspended international gold standard and reconstruct the European economy. Major countries such as the United States (June 1919) and the United Kingdom (April 1925) returned to the gold standard.

Japan chose not to join the other major countries in returning to gold during the 1920s. Policymakers debated whether to do so on at least three occasions, in 1919, 1923, and 1927. From a policy perspective, Japan had three options: a) the immediate restoration of the gold standard at the old parity, a move which would push the yen up from its present level; b) an eventual move to gold at the old parity, with sufficient time for preparation in advance; and c) a move to gold at a new parity, to keep the yen cheaper than it had been at the old parity. In all three of the policy debates referred to above, Japan chose to postpone the return to the gold standard.[16]

Japan had good reasons for not returning to the gold standard. Apart from instability in the domestic financial system, policymakers feared that Japan might be unable to sustain gold parity even after returning to the gold standard.

Japan recorded a persistent trade deficit during the 1920s after enjoying a massive trade surplus during the First World War. By running the trade deficit, the nation was losing the specie and foreign reserves it had accumulated during the War. The sum of the specie and foreign reserves decreased from 2,179 million yen (13.7 percent of GNP) at the end of 1920 to 1,199 million yen (7.3 percent of GNP) at the end of 1928.[17]

[Chart 5] Prices and Exchange Rates



Sources: Research and Statistics Department, Bank of Japan [1987], *Hundred-Year Statistics of Wholesale Price Indexes in Japan*; Asahi Shinbun Sha [1930], *Nippon Keizai Toukei Soran* (Pandect of Economic Statistics of Japan); Ministry of Finance, Financial Bureau [annual editions], *Kin'yu Jiko Sanko Sho* (Reference Book of Financial Matters); U.S. Department of Commerce, Bureau of the Census [1949], *Historical Statistics of the United States*; B. R. Mitchell [1988], *British Historical Statistics.*

Japan's persistent trade deficit of the 1920s was a consequence of waning competitiveness due to the high prices of domestic goods compared to foreign goods. Tracing the wholesale price index of Japan, the United States, and the United Kingdom, we find that prices in these three countries moved together at stable levels up to 1913, surged during and just after the First World War, and then plunged, albeit to a lesser extent in Japan. The price gap between Japan and its trading partners remained through to the end of the 1920s (Chart 5).

Aware that the gap between domestic and foreign prices was eroding the competitiveness of domestic industries, Japanese policymakers and business leaders sought to narrow the price gap and restore the gold standard.[18]

When the Hamaguchi Cabinet of the *Minsei-to* (ex-*Kensei-Kai*) Party came into power in July 1929, it was committed to the lifting of the gold embargo. Jun'nosuke Inoue, Hamaguchi's finance minister had put in a long career in international finance.[19] Judging from the restored stability in the domestic financial system, he concluded that the key precondition for returning to the gold standard had been satisfied. After cutting the budget for fiscal 1929 and 1930, he lifted the gold embargo in January 1930.

In retrospect, we see that the gold embargo was lifted in 1930 just when the Great Depression spread and deepened around the globe. Thus, the Japanese economy suffered debilitating effects from two sources, the impact of the worldwide depression and the appreciation of the yen associated with the return to the gold standard. The consequences, economically, were abrupt deflation and a severe contraction of economic activities in 1930 and 1931. Future observers were to call this "the Showa Depression."

The Showa Depression of 1930-31 was of a fundamentally different nature than the crises of the 1920s. The crises of the earlier decade had been problems of the domestic financial system. The Showa Depression of 1930-31, on the other hand, was induced by external factors, such as imported deflation, in combination with the appreciating currency and falling overseas demand.

When the United Kingdom departed from the gold standard in September 1931, international investors speculated that Japan would also be forced to follow suit soon. A rush to sell yen and buy dollars led to a massive outflow of capital. Finance Minister Inoue announced that the government would stay on the gold standard, and the BOJ raised the discount rate twice, in October and November. These measures failed, however, to bring about their desired effects:

the capital outflow continued until December, when the *Minsei-to* Cabinet[20] collapsed and the opposition *Seiyu-kai* Party came into power.

B. Departure from the Gold Standard and the Start of the "Takahashi Economic policy"

On December 13, 1931, when Tsuyoshi Inukai of the *Seiyu-kai* Party came to power, veteran Korekiyo Takahashi came back as Finance Minister for the fifth time in his career. Takahashi ordered a gold embargo on the day of his return to office. He went on to implement a series of economic policy adjustments over the next four years, until February 1936, when he was assassinated by militarists. His policy regime has since been referred to as the "Takahashi economic policy." As we see below, this was a three-pronged macroeconomic policy with exchange rate, monetary, and fiscal dimensions.

First, under the exchange rate policy, the yen was allowed to depreciate by 60 percent against the U.S. dollar and by 44 percent against the pound sterling, from December 1931 to November 1932.[21] Perceiving that a further depreciation of the yen would be unfavorable to the Japanese economy, the government took steps to stabilize the exchange rate. From April 1933, Yokohama Specie Bank, the official foreign exchange bank of Japan, set the exchange rate quotation in pound sterling, effectively pegging the yen to sterling. Meanwhile, foreign-exchange and capital controls in Japan remained mild through 1936.[22]

Second, fiscal expenditures increased, backed by deficit financing with the central bank's credit. A newspaper reported that Takahashi had mentioned the BOJ underwriting of government bonds for the first time on March 8, 1932, at a meeting with financiers.[23] On June 3, the government submitted a bill to issue deficit-covering bonds, together with a supplemental budget outlaying expenditures for military action in Manchuria (Northeastern part of Chinese Continent) and for an emergency relief program in rural areas. Then, on the same day, Takahashi officially announced the BOJ underwriting of government bonds. The bill and supplemental budget passed on June 18, marking a full-fledged start of the stimulative fiscal policy of the Takahashi era. The BOJ started underwriting government bonds on November 25, 1932.

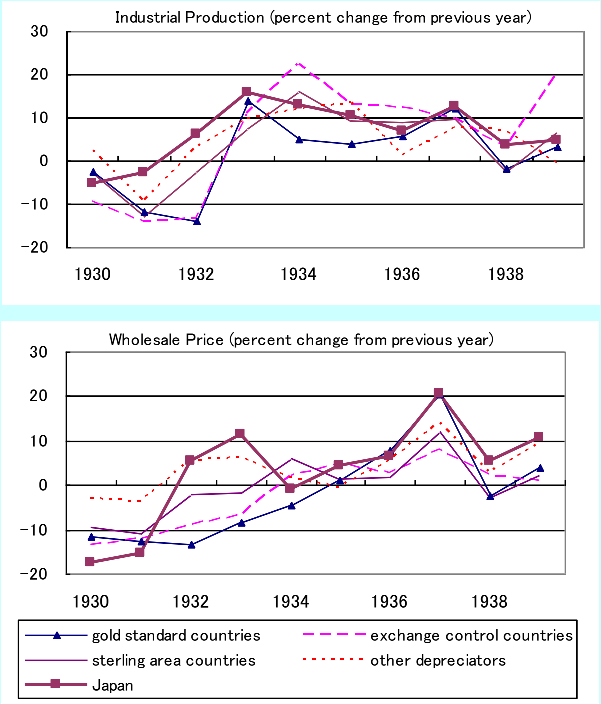
Third, the BOJ conducted an accommodative monetary policy by cutting its official discount rate in March, June, and August 1932. Meanwhile, the regulation on bank note issuance was amended in June to raise the limit of fiduciary note issuance from 120 million yen to 1 billion yen.

V. Transmission Mechanism of the Takahashi Economic Policy

A number of observers who focus on the macroeconomic aspects of the Takahashi economic policy praise Takahashi's achievements as a successful pioneer of Keynesian economics. Kindleberger points out that Takahashi conducted quintessential Keynesian policies, stating, "his writing of the period showed that he already understood the mechanism of the Keynesian multiplier, without any indication of contact with the R. F. Kahn 1931 *Economic Journal* article."[24]

The gist of this argument is that the macroeconomic stimulus policies during the Takahashi era contributed to growth in aggregate demand in Japan, and that Takahashi's macroeconomic policy consisted of a combination of three elements: a) depreciation of the yen (exchange rate policy), b) increase in government expenditure associated with the underwriting of deficit-covering bonds by the BOJ (fiscal policy), and c) interest rate cut (monetary policy).

[Chart 6] Production and Price Indexes



Source: League of Nations[1940], *Statistical Year-Book of the League of Nations*, 1939/40, pp.194-204.

Next, we compare economic performances of peripheral countries during the Great Depression in the 1930s. The peripheral countries at that time, countries similar to Japan as small and open economies, are divided into four categories: a) gold standard countries, b) exchange control countries, c) sterling area countries, and d) other depreciators.[25] Japan recovered earlier than these other peripheral countries: production and prices rose in Japan year-on-year by as early as 1932 (Chart 6).

Now, we review previous works done by economic historians and economists, focusing on the transmission mechanism of the Takahashi economic policy.

Nakamura [1983] employs a pioneering quantitative analysis focusing on the effect of the Takahashi policy on macroeconomic stability. Through this analysis, he concludes that the combination of exchange rate, fiscal, and monetary policies contributed to stability of the Japanese economy.

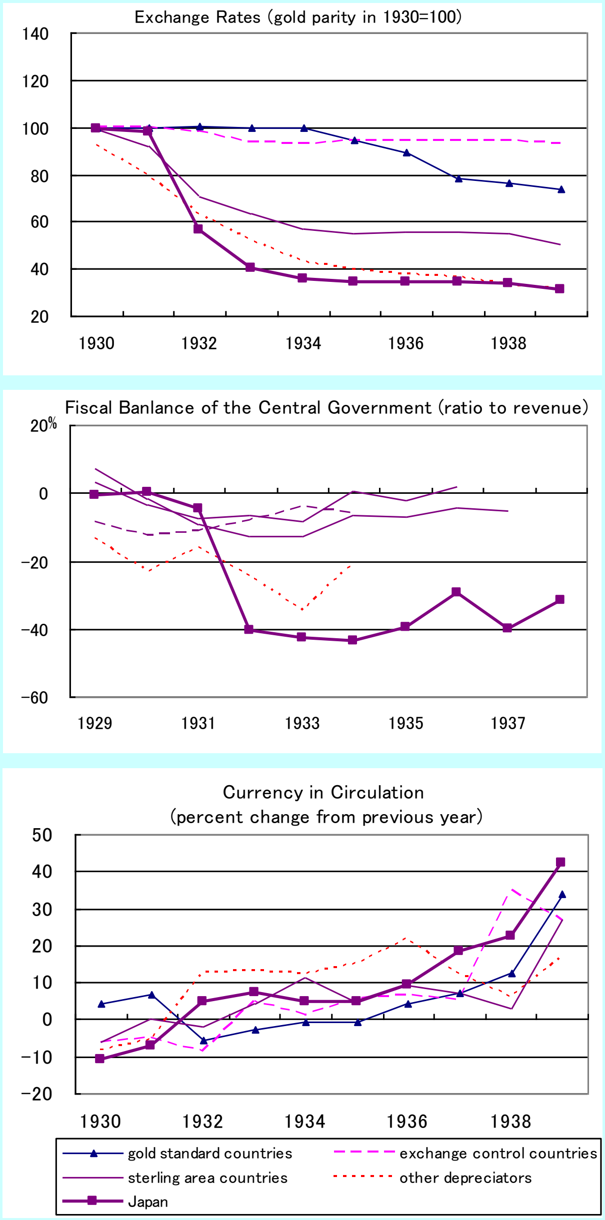
Since then, many scholars have focused on the direct effects of Takahashi's policies on demand and prices. Often they argue that external factors such as exchange rate movements played a pivotal role behind the increases in demand and prices. Nanto and Takagi [1985] emphasize the effects of the yen depreciation.[26] Okura and Teranishi [1994] discuss the effects of the move into Manchuria and fiscal stimulus, as well as the yen depreciation.[27] Umeda [2006] employs a vector-auto-regression (VAR) analysis with the following six variables: Japanese wholesale price index (WPI), foreign WPI, effective exchange rate, real fiscal expenditure (deflated by WPI), monetary base, and output gap (approximated by the deviation from the trend of production index). He finds, as a result, that Japanese prices were more strongly influenced by foreign prices and exchange rates than by domestic monetary and fiscal variables.[28] Cha [2003], on the other hand, stresses the important role of fiscal stimulus.[29]

Though recent research has examined how policy changes influence the expectation of future prices, many aspects of the transmission mechanism through this channel remain to be explored.

Empirical evidence shows a shift in expectation from deflation to inflation about the time when Takahashi commenced his economic policy. Yet the factors behind this shift in expectations remain unclear. Some argue that two events, namely, the departure from the gold standard (in December 1931) and the underwriting of government bonds by the BOJ (reported in March and commenced in November 1932), marked the turning points.[30] There is evidence to suggest, however, that market expectations were influenced significantly only by the departure from the gold standard, and not by the BOJ's underwriting of government bonds.[31]

Next, we compare macroeconomic policy between Japan and other peripheral countries during the Great Depression of the 1930s (Chart 7).

[Chart 7] Macroeconomic Policies of Japan and Other Countries



Sources: League of Nations[1940], *Statistical Year-Book of the League of Nations*, 1939/40, pp.194-204; Economic Intelligence Service, League of Nations [1937-38], *Public Finance*.

First, in exchange rate policy, Japan's currency depreciated more sharply than the other currencies in 1932, then moved in parallel with the currencies of the sterling area countries.

Second, in fiscal policy, Japan recorded much larger fiscal deficits than the other countries throughout Takahashi's term as Finance Minister in the 1930s.

Third, in monetary policy, currency in circulation (a measure of the quantity of money supply) rose moderately in Japan, as in sterling area countries, throughout Takahashi's term, and thus was no exception. Meanwhile, the Bank of Japan reduced its official interest rate three times in 1932, following the central banks of the United Kingdom and the United States.[32]

VI. Macroeconomic Policy Trilemma: the Japanese Case

Japan was a small, open economy during the entire interwar period, including Takahashi's term. The economy depended heavily on overseas markets, both in terms of trade and finance.

Policymakers and market participants at home recognized the small scale and openness of the economy. At the beginning of the Takahashi term, Japan depreciated the yen to a sustainable level and then pegged it to the pound sterling.

According to the notion of the macroeconomic policy trilemma, any chosen macroeconomic policy regime can succeed in achieving only two out of the following three policy objectives:

a) independent monetary policy oriented toward domestic objectives;
b) a fixed exchange rate; and
c) full freedom of cross-border capital movements.[33]

During Takahashi's term, Japan pegged its currency to the currency of the United Kingdom, a country which had been conducting a relatively lax monetary policy, and left cross-border capital regulations mild.[34] This implied that Japan was obliged to follow the monetary policy of the United Kingdom. Japan, meanwhile, increased its fiscal spending.

Other countries, such as Sweden and Denmark, chose options similar to Japan's. Specifically, they departed from the gold standard after the United Kingdom, depreciated their currencies against the pound sterling, and then pegged their currencies to the pound sterling. Through this approach, they achieved economic recovery earlier than the other European countries during the Great Depression.[35]

VII. The Takahashi Economic Policy and Fiscal Discipline

A number of previous works claim that the Takahashi economic policy, especially the underwriting of government bonds by the BOJ, led to easy credit for the government from the central bank, and a loss of fiscal discipline as a result.[36]

A number of recent studies discuss the issue of fiscal discipline in relation to political economy and international finance. Bordo and Rockoff [1996] argue that adherence to the gold standard by peripheral countries signaled prudent fiscal and monetary policies and improved the access to capital from core Western countries.[37] Shizume [2007a], meanwhile, observes that participation in international financial markets worked as a governance mechanism for maintaining fiscal discipline in Japan, even when Japan suspended the gold standard in the 1920s. Yet the British departure from the gold standard in September 1931 was a clear sign of the breakdown of the international gold standard: it eroded the rationale for staying on the gold standard, and hence the governance mechanism for fiscal policy through international finance. Japan, having apparently failed to establish a new governance mechanism for fiscal policy, introduced a way for the central bank to provide easy credit to the government.[38]

During Takahashi's term, there was virtually no formal mechanism for keeping the ever-growing budget demand to fund the military in check. Takahashi's presence was an agent of fiscal discipline in itself: the governance of fiscal policy depended on his own capabilities and will.[39] During the budgetary process of fiscal 1936, the Ministry of Finance, under Takahashi's leadership, tried to reduce the fiscal deficit. While it succeeded in reducing new government bond issues to some degree, the reduction was far from the level required. The negotiation increased tensions with the military, paving the way to Takahashi's assassination by a group of militarists on February 26, 1936. A complete loss of fiscal discipline ensued as Japan moved to a wartime command economy.

VIII. Concluding Remarks

We can draw a number of historical lessons from the Japanese experience during the 1920s and 30s.

First, Japan was unable to correct the instability of the financial system until the government adopted decisive measures on two fronts in the face of the financial crisis of 1927: the massive injection of public funds by indemnifying against the losses of the central bank, and structural reforms in the banking sector through the promotion of bank amalgamation and other measures of that sort.

Second, a combination of macroeconomic stimulus policies provided an effective way to deal with the world depression of the 1930s. Currency depreciation, fiscal stimulus, and easy monetary conditions helped Japan recover early from the Great Depression. We can note here that the shift in expectation from deflation to inflation was chiefly the result of the currency depreciation, not the BOJ underwriting of government bonds. The mechanism by which the expectation was formed in Japan was what we would expect in a small, open economy run under a fixed exchange rate system.

Third, Takahashi's regime lacked an institutionalized mechanism to govern fiscal policy. Fiscal discipline was maintained by the personal capabilities and will of Takahashi himself. Japan failed to establish a new mechanism to ensure fiscal discipline. And Takahashi's fiscal policy relied upon easy credit to the government by the central bank through the underwriting of government bonds. These policy settings weakened the governance of fiscal policy.

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1 Korekiyo Takahashi (1854-1936) was a distinguished financial and political leader in Japan. He joined the Bank of Japan (BOJ) in 1892 and served as Governor of the Bank from 1911 to 1913. He then went on to serve as Finance Minister seven times, between 1913 and 36, and as Prime Minister once, from 1921 to 22. He was assassinated by a group of militarists on February 26, 1936. Another distinction of his career in public service was his central role as a fundraiser in the Western countries during the Russo-Japanese War (1904-05). As we will learn later in this paper, Takahashi solved the financial crisis of 1927 and implemented a dramatic economic stimulus during the Great Depression.

2 In July 1937, Japan and China entered a state of war without declaring it. Japan was at war from that month until its surrender at the end of the Second World War in August 1945.

3 See Patrick, Hugh T. [1971], "The Economic Muddle of the 1920s," Morley, James William, ed., *Dilemmas of Growth in Prewar Japan*, Princeton University Press, pp.211-266, Princeton. Others, such as Nakamura [1983], call the 1920s an "era of unbalanced growth" for Japan, emphasizing the surge of urbanization and industrialization supported by public investment. See Nakamura, Takafusa [1983], *Economic Growth in Prewar Japan*, Yale University Press, New Haven.

4 Masuda Bill Broker Bank was headquartered in Osaka and had branches in the national and regional commercial centers of Tokyo, Nagoya, Kyoto, and Moji. See Tsurumi, Masayoshi [2000] "Senzen-ki ni okeru Kin'yu Kiki to Intaabanku Shijo no Henbo (Financial Crises and Changes in the Interbank Money Market during the Prewar Period)," Itoh, Masanao, Masayoshi Tsurumi, and Yoshio Asai, eds., *Kin'yu Kiki to Kakushin: Rekishi kara Gendai e* (Financial Crises and Innovation: From History to Present), Nihon Keizai Hyoronsha, Tokyo, pp.67-107; and Ehiro, Akira [2000], "Kin'yu Kiki to Kouteki Shikin Do'nyu: 1920 Nendai no Kin'yu Kiki eno Taiou (Financial Crises and the Injection of Public Funds: Policy Responses to the Financial Crises of the 1920s)," Itoh, Tsurumi, and Asai, eds., pp.67-107.

5 "Special loans" refer to various kinds of loans extended by the BOJ with special arrangements. They include loans exceeding a credit line per borrower, loans with extended coverage of collateral, and loans to borrowers who have no present ties to BOJ as clients.

6 See Tamaki, Norio [1995], *Japanese Banking: A History, 1859-1959*, Cambridge University Press, Cambridge, U.K., pp.141-142.

7 See Bank of Japan [1924], *Annual Report for the Year 1923*, Tokyo, p.V.

8 At the peak of panic on April 21, BOJ loans skyrocketed by 57 percent in just one day, to 602 million yen, and bank notes in circulation increased by 38 percent in just one day, to 639 million yen.

9 See Bank of Japan [1928], *Annual Report for the Year 1927*, Tokyo, pp.II-III; Tamaki [1995], p.152. The total government guarantees of 700 million yen accounted for 4.3 percent of the Gross National Product.

10 See Tamaki [1995], pp.155-164. According to Goto, Shin'ichi [1970], *Nihon no Kin'yu Toukei* (Financial Statistics in Japan), Toyo Keizai Shinposha, Tokyo, the year-end number of banks in Japan was 2,039 in the year 1920, and 1,427 in the year 1927. Then it decreased by 265 in just one year, by the end of 1928. In 1932, the number stood at 650.

11 See Tsurumi [2000], pp.100-101.

12 Fukai, Eigo [1941], *Kaiko Nanajunen* (Reflections on Seventy Years), Iwanami Shoten, Tokyo, p.225.

13 Takahashi, Kamekichi [1955a], *Taisho Showa Zaikai Hendou Shi* (A History of Economic Fluctuations during Taisho and Showa Eras), vol.2, Toyo Keizai Shinposha, Tokyo, p.739.

14 Takahashi, Kamekichi and Sunao Morigaki [1993], *Showa Kin'yu Kyoko Shi* (A History of the Showa Financial Crisis), Toyo Keizai Shinposha, Tokyo, p.289.

15 Takahashi, Kamekichi [1955b], *Taisho Showa Zaikai Hendou Shi* (A History of Economic Fluctuations during Taisho and Showa Era), vol.3, Toyo Keizai Shinposha, Tokyo, pp.1315-1316.

16 For details on the debates on the return to the gold standard, see Bank of Japan [1983], *Nippon Ginko Hyakunen-Shi* (Bank of Japan: The First Hundred Years), vol.3, Tokyo, pp.136-168; and Patrick [1971].

17 The amount at the end of 1914 was 341 million yen, or 7.2 percent of GNP.

18 See Bank of Japan [1983], pp.363-379; Takahashi, Kamekichi [1954], *Taisho Showa Zaikai Hendou Shi* (A History of Economic Fluctuations during Taisho and Showa Era), vol.1, Toyo Keizai Shinposha, Tokyo, pp.445-467.

19 Having served as Governor of the BOJ twice, he had close relationships with Benjamin Strong, President of the Federal Reserve Bank of New York, and Montagu Norman, Governor of the Bank of England.

20 Prime Minister Hamaguchi was shot in November 1930 and replaced by Reijiro Wakatsuki in April 1931.

21 Under the gold standard, the parity of one yen was equivalent of 49.845 U.S. cents and 2.0291 shillings. In

November 1932, the yen hit 20 cents and 1.14 shillings.

[22] Itoh, Masanao [2003], "Showa Shonen no Kin'yu Kiki: Sono Kozo to Taio," (Financial Crises at the Dawn of the Showa Era: Structure and Policy Responses), Abe, Etsuo ed., *Kin'yu Kisei wa Naze Hajimatta ka* (Why Financial Regulations Began?), Nihon Keizai Hyoron Sha, Tokyo, pp.155-193. Even though Japan introduced the Law Concerning the Prevention of Expatriation of Capital in July 1932 and the Law Concerning Foreign Exchange Control in May 1933, Japan's exchange controls during the Takahashi term were mild. Meanwhile, some European countries, such as Germany and Austria, imposed strict exchange controls. Importers and exporters in Japan were able to buy and sell foreign exchange freely via private banks until the end of 1937. Similarly, investors were free to buy and sell foreign securities, provided that they declared that the transactions were "not speculative."

[23] Osaka Nichinichi Shinbun, 9 and 10 March 1932. Also, on April 18, 1932, BOJ Governor Hisaakira Hijikata stated that the government intended to have the BOJ underwrite government bonds. BOJ Archives, 3943, "Documents from Meetings of Directors and Branch Managers, Spring-Autumn 1932."

[24] Kindleberger, Charles p. [1973], *The World in Depression, 1929-1939*, University of California Press, Berkeley and Los Angeles, p.166.

[25] See Shizume, Masato [2007b], "A Reassessment of Japan's Monetary Policy during the Great depression: The Constraints and Remedies," *RIEB Discussion paper* 208, Kobe University. The categorization is based on Eichengreen, Barry [1992], *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939*, Oxford University Press, New York, p.293 (Table 10.1).

[26] Nanto, Dick K., and Shinji Takagi [1985], "Korekiyo Takahashi and Japan's Recovery from the Great Depression," *American Economic Review* 75-3, pp.369-74.

[27] Okura, Masanori and Juro Teranishi [1994], "Exchange Rate and Economic Recovery of Japan in the 1930s," *Hitotsubashi Journal of Economics*, 35, pp.1-22.

[28] Umeda, Masanobu [2006], "1930 Nendai Zenhan ni Okeru Nihon no Defure Dakkyaku no Haikei: Kawase Reto Seisaku, Zaisei Seisaku, Kin'yu Seisaku" (On the Japanese Experience of Escaping from Deflation during the Early 1930s: Exchange Rate Policy, Monetary Policy, and Fiscal Policy), *Kin'yu Kenkyu* (Monetary Studies) 25-1, pp.145-181.

[29] Cha, Myung Soo [2003], "Did Korekiyo Takahashi Rescue Japan from the Great Depression?" *Journal of Economic History* 63-1, pp.127-44.

[30] See Iida, Yasuyuki, and Yasushi Okada [2004], "Showa Kyoko to Yoso Infure Ritsu no Suikei," (The Showa Depression and estimation of Inflation Expectation), Iwata, Kikuo ed., *Showa Kyoko no Kenkyu* (A Thesis on the Showa Depression), Toyo Keizai Shinposha, Tokyo. Iida and Okada [2004] argue that these two events shifted expectations in advance, as market participants anticipated them.

[31] See Shizume, Masato [2008], "Ryo-Taisen-Kan-Ki Nihon ni okeru Bukka Hendo Yoso no Keisei: Shohin Sakimono Kakaku Deta o Mochiita Bunseki (On Inflation Expectation during the Inter-War Period in Japan: An Analysis Using Price Data of Commodity Futures), *RIEB Discussion Paper* J97, Kobe University. Shizume [2008] argues that the departure from the gold standard had significant effects on expectations, while the BOJ underwriting of government bonds had no such effect. He draws his conclusions from a quantitative analysis based on commodity futures prices, and a narrative analysis based on comments of contemporary market participants. The markets, he reports, anticipated the Japanese departure from the gold standard, as well as the resulting inflation and currency depreciation in the face of Britain's departure from the standard. He also finds that markets did not anticipate inflation when the debt-financed public spending and BOJ underwriting of the national debt were announced.

[32] Shizume [2007b] argues that the long-term interest rate in Japan moved along with the British rate.

[33] See Obstfeld, Maurice, and Alan M. Taylor [2004], *Global Capital Markets: Integration, Crisis, and Growth*, Cambridge University Press, Cambridge and New York. Obstfeld and Taylor [2004] apply the concept of the macroeconomic policy trilemma in their historical studies on the relationship between the currency systems and monetary policies of a number of countries. They argue that the gold standard system is a typical policy regime designed to maintain free capital movements and a fixed exchange rate, while sacrificing independent monetary policy.

[34] Itoh [2003], p.156.

[35] Eichengreen [1992], pp.298-309.

[36] For details on this argument, see, for example, Ministry of Finance [1965], *Showa Zaisei Shi* (A Financial History of Showa Era), vol.1, Tokyo, pp.134-140; and Shima, Kinzo [1983], "Iwayuru Takahashi Zaisei ni Tsuite" (On the So-called Takahashi Economic Policy), *Kin'yu Ken'kyu* (Monetary Studies), 2-2. Along this line, the underwriting of government bonds by the central bank was prohibited in Japan under Article 5 of the Finance Law of 1947.

[37] Bordo, Michael D., and Hugh Rockoff [1996], "The Gold Standard as a Good Housekeeping Seal of Approval," *Journal of Economic History* 56-2, pp.389-428.

[38] Shizume, Masato [2007a], "Sustainability of Public Debt: Evidence from Pre-World War II Japan," *RIEB Discussion paper* 201, Kobe University.

[39] Though Takahashi advocated the use of fiscal policy during a recession, he recognized the importance of fiscal discipline in the long-run. See Smethurst, Richard J. [2007], *From Foot Soldier to Finance Minister: Takahashi Korekiyo, Japan's Keynes*, Harvard University Press, Cambridge (Massachusetts) and London.

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