INTERNATIONAL CURRENCY REALIGNMENT AND THE YEN

TAKASHI MURANO

I. INTRODUCTION

THE READJUSTMENT OF the foreign exchange rate system which took place in December 1971 on a worldwide scale, the so-called multilateral currency realignment, was intended to redress the maladjustment which had been aggravated within the system over a long time. Its real nature, however, should be regarded as the final step in the long process of decomposition of the gold exchange standard system that centered around the United States, with the U.S. dollar as the most important key currency. This system had been decaying after the suspension of the convertibility of the dollar from August of 1971.

As the breakup of the gold exchange standard system is not included directly in the subject of the present paper, detailed comment will not be made here, but briefly it can be concluded that this event was proceeded by the behavior of the United States economy which made chronic and substantial balance-of-payments deficits unavoidable. These deficits resulted in massive accumulations of liquid external dollar liabilities and the deterioration of official U.S. gold reserves, leading to the consequent cooling down of the international confidence in the U.S. dollar. Can the occurrence of that process of decomposition be attributed primarily to the functioning of the self-controlling powers of the U.S. economy? Or, is it justifiable to do so? Or, is it not that some exogenous influences, for instance, policies of other countries, resulted in giving their currencies positions superior to that of the U.S. dollar, which thus gave rise to the crisis of the dollar and led to the decay of the international monetary system? More concretely, was it not the extraordinarily large surplus in the balance of payments of Japan, which was the major cause of the payments deficit of the United States, that worked to overthrow the United States external position and contributed to the evidently excessive overvaluation of the U.S. dollar leading to the consequent deterioration of international confidence of the dollar? Attempts to probe into the factual bearing of these phenomena with such points of view in mind may well be considered as forming an academic study.

In the following, an examination is attempted first of the causes which necessitated the multilateral currency realignment. Secondly, an attempt is made to clarify the fact that the Japanese yen, which had been set up as one of the local currencies in 1949 at the time of Japan's entry into the International Monetary Fund, had grown into a very strong currency several years before the currency realignment. Then, thirdly, an assessment and evaluation are attempted of the present position of the yen in the newly introduced central rate system, after the yen underwent a drastic change in its par value of 16.88 per cent under the international agreement on multilateral currency realignment.

II. THE POSTWAR GOLD EXCHANGE STANDARD SYSTEM

What made the Smithsonian multilateral currency realignment necessary? In order to answer this question, let us first make a brief historical review of the gold exchange standard system, which was based on the organization of the International Monetary Fund created immediately after the termination of the last world war.

It is well known that a gold exchange standard had already been functioning as an international monetary system in the years before World War II. Both the prewar and postwar gold exchange standard systems are theoretically of the same nature, in that the country standing in the center of the system guaranteed the conversion into gold of its currency. Other countries held foreign exchange denominated in that pivotal currency as the official reserves for their external payments and as international currency holdings, as well as reserve assets backing their domestic currencies. From the viewpoint of structure, however, the prewar and postwar systems differed greatly. In particular, the most outstanding difference is seen in the fact that the system in prewar years was formed around more than one central country, namely the United States and the United Kingdom, and involved two key currencies, the U.S. dollar and the pound sterling, in contrast to the system in the postwar years which centered around a single country, the United States, and a single currency, the dollar.

The postwar system was a product of the worldwide international agreement establishing the IMF organization, which was not found in the prewar system. In this sense the postwar system had a sort of logical framework originally built into itself, unlike the prewar one. A comparison of the two systems, each as a whole, reveals that, while both were the products of international monetary history, the system in the postwar years was theoretically better organized and was more rationally systematized than that in the prewar years. However, a look into the details of the systems makes it clear that the theoretical orderliness and rationality of the postwar system were not really valid internationally, but were more rational for the central country, i.e., the United States, than for other countries. The postwar system was obviously dominated by the American theories underlying it. The reasons for this will be summarized in the following paragraph.

The factors making up the gold exchange standard system comprise the central country and the key currency, the various other countries of the world and the local currencies of these countries, and the International Monetary Fund. The details of the functioning of the gold exchange standard as an international monetary system will be examined hereinafter, but it should be remembered that all types of international monetary system must be composed of the following three basic components: (1) a system of international liquidity supply, (2) an adjustment process of the balance of payments, and (3) a means of assuring confidence in the key currency and other currencies, and, thus, to maintain confidence in the system itself. Also worthy of note are the interrelations of these three factors, namely, the relation between the volume of liquidity and the speed of the adjustment process, and the relation of both the volume of liquidity and the degree of confidence to the efficiency of the adjustment process.

A. *International Liquidity and the Adjustment Process*

The demand for international liquidity of the various countries, other than the United States, is supplied from the gold and foreign exchange held by these countries as their primary reserves for external payments. When any country faces demands for international liquidity exceeding its primary reserves, it may resort to the International Monetary Fund. But, under the present conditions in which the IMF generally is not authorized to create credit, the capacity of the IMF to supply liquidity is limited to the extent of the contributions made to it by the member countries. From its outset, the IMF has been an international organization with only limited functions in regard to the supply of liquidity. The country which failed to have its demand for liquidity supplied by the IMF has then turned to the United States, whose capital accumulations used to be substantial. The United States thus has been the so-called lender of last resort.

The postwar system has drawn a lesson from the violent blows inflicted on the international economy by the series of competitive currency devaluations throughout the world in the 1930s. Such competitive devaluation was strictly proscribed in Article 4 of the IMF agreement, which reads to the effect that changes in the par value of a currency may be permitted only when the country faces "fundamental disequilibrium." Thus, the basic principle that exchange rates should be strictly maintained as long as possible is presented. The basic system of the IMF differs from the gold standard system only in the emphasis on this fundamental disequilibrium provision. This provision, at the same time, was an embodiment of the policies of the American economy, which had been exercising hegemony over the international monetary system after World War II. The world economic policy of the United States is so constituted as to be workable most efficiently under conditions of stability in the exchange rate structure.

This system is directly opposite to the basic idea which underscored the international clearing union proposed by Keynes as his ideal postwar international monetary system, in which any country which happens to have outstanding credits or debts due to or from the clearing union exceeding the limits prescribed by the agreement would be obliged to carry out revaluation of its currency upward or downward, virtually automatically. Keynes was apprehensive of the aggravation of the chronic deficits in the balance of payments of the United Kingdom and intended to redress them by means of a structural renovation of the international monetary system. The IMF system of exchange rates, which is featured by the gold standard ideology, forces its member countries to sustain their par values (external equilibrium) by means of increases or decreases in domestic prices, and consequently through expansionary or deflationary economic policies.

B. *Means of Maintaining Confidence*

Any sort of monetary system, not to speak of money itself, is far more vulnerable to both endogenous and exogenous influences than systems composed of physical production and exchange. This may be readily conceded when one compares the GATT and IMF systems. The stability of the gold exchange standard system is mostly dependent on the degree of international confidence in the key currency. Then, what are the conditions or means of assuring confidence in the U.S. dollar? They are the following, which will be called the superstructure and infrastructure hereinafter. The superstructure is a structure in which the U.S. dollar, that is a national currency of the United States and at the same time is one of the international currencies, maintains convertibility into gold and adequate reserves are maintained in order to fulfill foreign countries' demand for payments readily in gold for their claims in dollar terms, at any time and in whatever amount when such demand is made. The infrastructure is a structure in which the United States, the central country, keeps holding its external payments in a positive balance on current account at least basically, if not cyclically, to be ready to meet the demand for liquidity from the other member countries.

The relationship of the maintenance of confidence to the above-mentioned system of international liquidity supply and the balance-of-payments adjustment process is as follows. When the adjustment processes in the various countries are progressing smoothly, required amounts of liquidity or external reserves are relatively small, the supply of U.S. dollars required for this purpose is not excessive, and thus confidence is sustained. When liquidity is adequate, or abundant, the process of adjustment is usually apt to be managed rather carelessly so that demands for the central country's creation of liquidity increase in excess of current account requirements, and in turn the convertibility into gold of the key currency is made difficult, thereby leading to a deterioration of the confidence in the U.S. dollar.

How is the degree of confidence in a local currency ultimately related to the degree of confidence in the gold exchange standard system, and to the crisis and collapse thereof? In a situation where confidence in the U.S. dollar is impaired, low regard for the U.S. dollar prevails and gives rise to a preference for other currencies and for gold. However, the low regard for the U.S. dollar does not necessarily cause a preference for gold. Even if gold is preferred to dollars, a preference for other currencies may also take place concurrently, i.e., a preference for a stable local currency. Canadian dollars and Deutschemarks have often been favored in preference to U.S. dollars during the dollar crisis, and that is why the preference for gold has been moderate. The importance of the stability of local currencies, which plays significant role in sustaining confidence in the U.S. dollar, and in turn in the gold exchange standard system, implies the significance of the behavior of the various countries other than the central country.

As one of the reasons why the recent multilateral currency realignment was inevitable, which is the primary subject of this paper, the past, present, and probable future policy measures of Japan with regard to the stability of the yen, should be studied, in view of the importance of the behavior of countries other than the United States. What this means in substance will be clarified in the course of the explanation of the functions of the gold exchange standard system in the following section. Here, in connection with the means of assuring confidence, it has to be recalled that the primary cause of inappropriate functioning, and eventual deformation, of the gold exchange standard system has not necessarily been found solely in the central country, as is widely believed. Some causes also have been found in Japan and Western European nations. It is undeniable that no appropriate feedback mechanism of gold return has been maintained between the United States and these other nations.

In concluding the present analytical review of the structure of the gold exchange standard system, the following quotation from *International Monetary Arrangements: The Problem of Choice*, Report on the Deliberations of an International Study Group of 32 Economists, is worthy of note for a clear understanding of the basic nature and weakness of the gold exchange standard system:

> The present system, which relies on deficits of reserve-currency countries to supplement the growth of monetary gold reserves, cannot continue indefinitely; since the system necessitates a progressive increase in the ratio of the liquid liabilities of the reserve-currency countries to their gold holdings, it creates a growing threat to the value of the reserve holdings of other countries, with the result that confidence in the stability of the system is undermined. [3, p. 74]

However, I do not fully agree with this statement. In particular, I am not of the opinion that "the system necessitates a progressive increase in the ratio of the liquid liabilities of the reserve-currency countries to their gold holdings." In my view, rather than the system necessitating, instead, the system is forced into such a situation because the other countries do not feed back the sizable gold holdings which they have accumulated. If this feeding-back were carried out smoothly, gold reserves of the United States would increase, thereby improving certainty of the convertibility of the U.S. dollar into gold, and "confidence in the stability of the system" would not be undermined. In other words, the primary responsibility for the maintenance of confidence does not rest solely on the central country, but should be partly borne by countries whose balance-of-payments surpluses are substantial and gold reserve holdings are sizable. In the following section a detailed examination is made of this problem.

C. *Weakening of the U.S. Dollar*

The circumstances in which the gold exchange standard system developed and its basic nature as an international monetary system have been outlined. In this section the functioning of the system will be examined, beginning with a review of the United States balance of payments, which constitutes the infrastructure which has been responsible for the strength and weakness of the U.S. dollar, i.e., the degree of confidence in the key international currency.

As shown in Table I, the balance of payments of the United States in 1946 through 1950 reported substantial surpluses on trade account. However, as government overseas payments on capital account were substantial, the surplus

TABLE I
BALANCE OF PAYMENTS OF THE UNITED STATES
(Annual average in millions of dollars)

	1946–50	1951–57	1958–66	1967–70
Current account	6,697	4,749	4,808	−254
Visible trade	5,716	3,223	4,344	845
Invisible trade	917	1,525	464	1,926
Government external payments	−5,586	−4,805	−2,264	−810
Private capital transactions	−825	−1,360	−3,988	
Errors and omissions	611	209	−432	−3,212
Overall balance of payments	897	−957	−2,652	−7,634

Source: U.S. Department of Commerce, *Survey of Current Business.*

in the overall balance of payments averaged only $900 million. From 1951 through 1957, the surplus on current account contracted appreciably as United States exports to Western Europe declined due to progressing postwar rehabilitation and reviving production in other countries, especially those in Europe. On the capital account side, the increase in private overseas investment more than compensated for the decrease in government overseas payments. As a result, the overall balance of payments showed a deficit of $1 billion. For 1958 through 1966, the current account remained about the same as in the preceding years, while sharp increases in private overseas investment continued to more than offset decreases in government overseas payments, thereby causing a sharp rise in the deficit on overall account, which averaged as large as $2.7 billion.

The U.S. trade balance recorded deficits for some years in the 1967–70 period, reversing the long-sustained surplus balance which had been uninterrupted after the war. Due to such an epoch-making change in the current account performance, the overall balance of payments continued to register increasingly large deficits. These continuing U.S. balance-of-payments deficits clearly imply structural weakness embodying the trade deficits mentioned above. A detailed analysis of this phenomenon will be attempted later, but it should be noted here that such a grave deterioration of the balance of payments undoubtedly has worked as a significant cause for the subsequent inevitable weakening of confidence in the U.S. dollar.

Now let us turn to the superstructure, that is, the external short-term liabilities (those held by public institutions, foreign banks, and private individuals, combined) and gold reserves maintained by the United States. As Table II shows, short-term external liabilities in 1949, immediately after the war, amounted to about $6 billion (no sectoral breakdown available), while gold reserve holdings approximated $24.6 billion, indicating the outstandingly strong external credit position of the United States. By 1954 the liabilities had increased to about $11.2 billion, while gold reserves had decreased to $21.8 billion. Short-term external liabilities continued to expand and gold reserve holdings continued to contract until 1959 when the amounts of short-term external liabilities and gold reserve holdings were nearly equal, at about $19.4 billion and $19.5 billion, respectively.

TABLE II
SHORT-TERM EXTERNAL LIABILITIES AND GOLD RESERVE HOLDINGS OF THE UNITED STATES

($ billion)

	Gold Stock	Liquid Liabilities to Foreigners	Of Which	
			Official Institutions	Others
1949	24.56	5.96	—	—
1954	21.79	11.15	—	—
1959	19.51	19.43	10.12	7.62
1964	15.47	29.00	15.42	11.06
1966	13.24	29.78	13.66	14.21

Source: Board of Governors of Federal Reserve System, *Federal Reserve Bulletin*, December 1961 and December 1970.

However, the newly published breakdown of the short-term external liabilities showed that about $10.1 billion was due to official institutions of foreign countries and about $7.6 billion was due to the private sectors of foreign countries. Thus, the holding of gold reserves against the short-term liabilities to foreign official institutions (for which the United States was committed to settle in gold) were fairly adequate. But by 1966 short-term foreign official liabilities of $13.7 billion exceeded the $13.2 billion holding of gold reserves. This discrepancy between short-term external official liabilities and gold reserves continued to grow until President Nixon finally declared a temporary suspension of the convertibility of the U.S. dollar into gold August 1971. In this way, the superstructure of the system supporting confidence in the U.S. dollar has been allowed to be undermined since the occurrence of the dollar crisis, despite the increasingly worsening situation.

The continued deterioration of the ratio of gold reserve holdings to liabilities in the United States' external short-term credit position, together with the chronic and sizable deficit in the U.S. balance of payments culminated in 1971 with the United States being forced to suspend conversion of the dollar into gold, and U.S. dollars became mere inconvertible paper money, bringing the gold exchange standard system to an end. This collapse of the dollar may well imply the grave importance of the predictive statement of the international study group of economists cited above in signalling dangers of the nearing collapse of the gold exchange standard system [3].

D. *Roles of the Surplus Countries*

As the study group pointed out the United States must be blamed for its incessant overseas investment activity beyond the limitations set by the surplus on the current account, which led to increasing gold outflows and accumulations of short-term external liabilities, and finally to the crisis and collapse of the U.S. dollar. However, the development of the process described above would have been quite different if Japan and the Western European countries, which attained large balance-of-payments surpluses against the United States and consequently large accumulations of reserve holdings, had induced changes in their policies for adjustment in domestic conditions and relaxation of the strict controls over trade and capital transactions. The gold which was substantially accumulated in Western European countries would have then flowed back to the United States. At the same time, the fundamental disequilibrium of Japan would have been redressed, with the huge excess of receipts over payments from the United States having probably decreased.

The Smithsonian agreement for multilateral currency realignment was a case of the above-mentioned international adjustment. It took place too late, however. The upward changes in exchange rates, viewed objectively, were considerable, but trade and capital liberalization, that were to be undertaken in order for the effects of the exchange rate changes to be fully realized, have failed to be enforced satisfactorily.

The Western European countries, excluding the United Kingdom, though varied in degree, have all been traditional gold-loving nations, as is widely known. As these countries emerged from large balance-of-payments deficits after World War II, especially with the United States, and began to enjoy surplus balances, they deliberately started accumulating gold. As a result, the gold reserve holdings of the Western European countries expanded, especially in the original six EC countries, with the holdings of France alone nearly approximating those of the United States. This behavior of gold accumulation involved in itself certain problems.

The gold exchange standard system assumes that a major part of the gold reserves is held by the central country, and the other countries hold foreign exchange denominated in the key currency. It is not necessary in practice that all gold be concentrated in the central country, but it is "a rule of the game" to be observed in the gold exchange standard system to feed back a large portion of the gold holdings of various countries to the central country. To this end, every country which has a substantial and growing balance-of-payments surplus must take appropriate adjustment policy measures to control or prevent further growth of the surplus, such as, for instance, measures to discourage exports and to promote imports, as well as to expand aggregate domestic demand. Or an attempt must be made to attain the same end by means of an upward revaluation of the currency which is unduly undervalued. Actually, however, until very recently none of the Western European countries has carried out such income or exchange policies.

Since, unlike the gold standard system, automatic adjustment cannot be expected of the system, enforcement of special policies for balance-of-payments adjustment is necessary. The implementation of adjustment policies might have forced Western European countries, which were suffering from rising inflation, to bear some additional sacrifices, such as slower growth rates. These probable costs arising from the enforcement of adjustment policies are not necessarily unavoidable. It is conceivable that expansionary policies or exchange policies could have put a controlled feedback mechanism into action to moderate the fundamental disequilibrium in the United States balance of payments without undue disruption of other nations' economies. These policies should have realized return-flows of gold into the United States or, at least, have checked, the decrease in the gold holdings of the United States. International cooperation only sufficient to check the deterioration of confidence in the U.S. dollar certainly would not have been a very difficult effort in those days. It is true that since the occurrence of the dollar crisis the development of international cooperation to assist the U.S. dollar defense policies has had considerable scale and strength. But, this cooperation has not been powerful enough to serve as a broad feedback mechanism able to change the direction of the balance of payments and the flow of gold. Rather than producing effective precautionary measures, this international cooperation only amounted to symptomatic treatment, or allopathy, as the dollar defense policy actually proved to be.

Along with the other countries', Japan's cooperation has not made much of a contribution, and is hardly worthy of being termed cooperation. However, despite the increasingly substantial accumulation of dollars, Japan remained stricter than any other country in limiting the purchase of gold from the United States. In the long evening before the multilateral currency realignment, Japan did continue to buy U.S. dollars, which were then rushing in, at the IMF par value. This step turned out to be largely meaningless in the existing conditions, since various strict control measures were in force, such as import restrictions and high tariff rates, together with the restrictions banning capital imports.

III. JAPAN'S RELATIONSHIP TO THE SMITHSONIAN REALIGNMENT

A. *Strengthening of Japan's Balance-of-Payments Position*

The postwar recovery of the Japanese economy from the deadly blows dealt by the last world war was surprisingly rapid. This successful recovery, further extended by the economic development policy undertaken in the early 1960s, brought about a high and sustained growth rate unparalleled in the world, creating strong productivity and making Japan a most forceful competitive power in international markets. However, Japan's balance of payments over the years, from World War II through the middle of the 1960s, had been basically in deficit. A closer review, of course, reveals the decreasing deficits in the early years being converted to the well-established surpluses of recent years. Statistical illustration of the recent strengthening in the surplus balance is given in Table III.

One of the reasons for the remarkable change in the balance of payments performance is the fact that Japanese industry has grown to possess a superior competitiveness in international markets. The Ministry of International Trade and Industry has been very much interested in this aspect, and has published the results of surveys and studies on competitive power in its annual foreign trade white papers. Table IV is based on the white paper for 1972, showing the ministry's evaluation of Japan's export competitiveness [4]. This table shows how different factors contributed to the expansion of exports from selected major

TABLE III
BALANCE OF PAYMENTS OF JAPAN

($ million)

	Current Account						Overall Balance
	Balance	Trade Balance	Exports	Imports	Services	Transfers	
1963	−780	−106	5,391	5,557	−569	−45	−161
1964	−480	377	6,704	6,327	−784	−73	−129
1965	932	1,901	8,332	6,431	−884	−85	405
1966	1,254	2,275	9,641	7,366	−886	−135	337
1967	−190	1,160	10,231	9,071	−1,172	−138	−571
1968	1,048	2,529	12,751	10,222	−1,306	−175	1,102
1969	2,119	3,699	15,679	11,980	−1,399	−181	2,283
1970	1,970	3,963	18,969	15,006	−1,785	−208	1,374
1971	5,797	7,787	23,566	15,779	−1,738	−252	7,677

Source: Bank of Japan, *Economic Statistics Annual 1972*, 1973.

TABLE IV
FACTORS OF EXPORT GROWTH IN MAJOR COUNTRIES

(Per annum, %)

	1955–63				1963–70			
	Growth Rate	Scale Factor	Price Factor	Non-price Factor	Growth Rate	Scale Factor	Price Factor	Non-price Factor
	$A \doteqdot B+C+D+E^a$	B	C	D	$A \doteqdot B+C+D+E^a$	B	C	D
Japan	13.7	5.0	1.2	2.0	18.2	5.8	0.9	3.1
Canada	3.9	2.1	0.6	−3.4	11.3	2.7	−2.0	3.0
U.S.A.	3.7	1.6	−1.6	−1.0	6.5	2.1	−1.6	−1.3
Belux	7.5	1.9	1.0	−0.3	11.3	2.5	0.2	1.0
Netherlands	7.3	2.0	−0.6	1.0	11.9	3.2	0.8	0.3
West Germany	10.0	3.4	−1.9	3.5	10.8	2.5	−0.0	−0.7
France	6.6	2.9	0.8	−2.0	10.2	3.1	0.4	−0.8
Italy	14.9	3.2	3.0	3.1	13.1	2.8	0.9	1.5
United Kingdom	2.8	1.5	−2.4	−1.0	5.5	1.4	0.5	−3.6
Sweden	7.5	2.2	−0.4	0.8	8.8	2.4	−0.9	−0.1
Denmark	7.2	4.4	0.3	−2.3	7.3	2.5	0.9	−3.4

Source: [4, p. 247].
Note: Averages of factors C and D for eleven countries equal zero, respectively.
[a] Factor E represents the increase of export proportionate to that of world trade, which was 4.8 per cent per annum for 1955–63 and 7.4 per cent per annum for 1963–70.

countries, and indicates changes in the international competitiveness of each country. According to the white paper,

> Japan's real exports increased at an annual rate of 18.2 per cent from 1963 through 1970, of which 5.8 per cent was accounted for by the enlarged scale of supply capacity; 0.9 per cent by increased price-competitiveness; 0.3 per cent by increased non-price competitiveness; and the rest by the increase in the world trade, which was commonly shared by all other countries. [4, p. 246]

Table IV shows the situation which prevailed in the years 1955 to 1963 and 1963 to 1970. During the first period, "the increase in exports due to the strengthened competitiveness of Japanese exports, portions attributable to both price and non-price factors, accounted for 3.2 per cent, the second highest figure after Italy." Subsequently, in the second period, "the enhancement of Japan's export competitiveness topped all other nations at 4.0 per cent." The white paper summarizes these facts and concludes that "Japan's export competitiveness, insofar as it is measured in relation to ten other countries, seems to have achieved a rapid improvement both in the price and non-price phases" [4, p. 247]. The white paper also examines the performances of non-price factors (e.g., supply capacity, advertising quality, brand identification, postsale service) in Japan's export competitiveness and points out that there is considerable room for further improvement in export competitiveness of Japan due to non-price factors. The fact that the contribution made by non-price factors toward export growth increased from 2.0 per cent in the first period to 3.1 per cent in the second clearly shows the qualitative improvement of Japan's international competitive power. This improvement of competitive power was one of the major reasons for the consolidation of the trade surplus and the huge accumulation of balance-of-payments surpluses. As will be discussed later, these surpluses are so large and well institutionalized that they may not be easily remediable by such countermeasures as liberalization of imports, not to mention such an extraordinary measure as "anpassungsinflation," but may even require adjustment by change of industrial structures and upward revaluation of the exchange rate.

B. *Japanese Trade Policies*

Another reason for the unusually large surplus in Japan's balance of payments is found in the completely organized system of strict, extensive, and minutely prepared policy measures for promoting exports and restricting imports. There is no comparable system in other countries. Some major policy measures for export promotion (preferential treatment) in Japan are, on the side of finance, the export trade bill system and foreign exchange loan system; on the side of taxation, the special allowance for depreciation on exports, the overseas market development reserve system, the reserves for overseas investment losses, the special deduction of taxable income relating to technological and other overseas transactions, and tax exemption of social expenses. In addition, there have been systems for compensating export risks on the part of export insurance functions (some of which still continue in effect).

As is well known, modernization of the Japanese economy took place considerably behind other major countries. Furthermore, since Japan's domestic market is limited, it has been vital for Japan to increase export income for attainment of its economic development. Under these conditions, it was justifiable that Japan resorted to such policies to promote exports. The various policy measures for export promotion, however, were accompanied by the development of measures for restriction of imports. Japan has achieved growth of exports and replacement of imports by expanding its productive capacity. This performance of export promotion coupled with import restriction was not necessarily aimed at realizing the trade surplus based on mercantilism. It rather represented Japan's need for protection of immature industries due to delayed growth and hasty modernization. These trade and external payment policies were most peculiar to Japan in nature, as comparison with similar policies in Western European countries makes clear. These policies have been followed by Japan without any substantial change, even after the Japanese economy has acquired unrivalled competitive power in international markets.

My personal view is that Japan's balance-of-payments, or trade, policies are based on economic nationalism, which is incompatible with, or quite opposite to, economic internationalism. This economic philosophy of Japan is fundamentally different from that of Western European countries, where economic nationalism is compatible with economic internationalism. These two sorts of economic nationalism (Japanese and European) materialized in the form of balance-of-payments and trade policies of quite different natures. In the case of Japan, the pursuit of national interests did not admit international interests; national interests tended to reject international interests. There was no thinking in Japan to have national interests secured or expanded by means of admitting international interests. In contrast, Western European countries in their pursuit of national interests take account of due coordination with international interests, thereby intending to secure expansion and assurance of national interests.

The change in Japan's position in the world economy has been forcing this peculiar economic nationalism to undergo a change. To be sure, it is now showing signs of a tendency to change into a philosophy more like that in Western European countries. This tendency is underscored by the recently rising advocation of the necessity of internationalization of the Japanese economy, international cooperation, and the like. However, the heated discussions about the justifiability of the revaluation of the yen have made us realize how stubborn Japanese industry is in sticking to Japanese-style economic nationalism. Even now that they should have learnt precious lessons from the last revaluation, and with another revaluation looming ahead, the opposition expressed by industry is astonishingly strong, showing the persisting prevalence of economic nationalism in Japan. This suggests the difficulty of the fulfillment of Japan's role in the reformation of the international monetary system, as explained later.

The balance-of-payments and trade policies based on the above-mentioned philosophies have taken the following forms: External payments and imports are restricted in principle with exceptions free in Japan, making a sharp contrast with Western European countries, where international transactions are free in principle with exceptions restricted. It is a well-known fact that Japanese policy of this type was an important deterrent to earlier relaxation of exchange control and import liberalization. Table V gives statistical data showing how slowly the progress in Japan's import liberalization has been realized, and illustrates the actual situation of liberalization just before the yen revaluation of 1971. Table VI shows a comparison between Japan and some major countries of the number of import items which were still under control as of December 1969.

TABLE V
IMPORT LIBERALIZATION IN JAPAN

	Number of Non-liberalized Items			Number of Residual Items to be Freed Later		Liberalization Rate
	All Commodities	Agricultural, Forestry, and Fishery Products				
		Total	Excluding Such Items as Rice, Wheat, Rye, Barley, Malt	All Commodities	Agricultural, Forestry, and Fishery Products	(%)
April 1962	493	—	—	—	—	41*
September 1963	192	79	76	155	76	92
February 1966	167	77	73	124	73	93
October 1969	161	77	73	118	73	93
February 1970	152	71	67	109	67	94
April 1970	141	64	60	98	60	94

Source: [1, p. 169].
* April 1960.

TABLE VI
INTERNATIONAL COMPARISON OF THE NUMBER OF RESIDUAL IMPORT ITEMS UNDER CONTROL
(As of December 1969)

	Total	Manufactured Goods	Agricultural Products
Japan	118	50	68
United Kingdom	25	6	19
Canada	4	1	3
France	74	35	39
West Germany	39	20	19
Italy	20	8	12
Sweden	2	0	2

Source: [1, p. 170].

Japan's import liberalization has been especially accelerated since June 1960 when the government introduced its basic program of trade and exchange liberalization. Since the rate of liberalization was only 40 per cent in April 1960, the liberalization thereafter shows a remarkable advance. An international comparison as seen in Table VI, however, readily reveals the considerable delay of liberalization in Japan.

One of the most important aspects of Japan's recent balance-of-payments pattern is reflected in the rising surplus in the trade balance with the United States. Table VII shows the development in the United States' trade balances with various countries, and Table VIII gives the distribution of various trading partners' contribution toward the deterioration of the trade balance of the United States. Neither of these tables need further explanation. Briefly, the most important cause for the worsening of the U.S. trade balance was the deterioration

TABLE VII

CHANGES IN THE U.S. BALANCE OF TRADE BY COUNTRY

($ million)

	Japan	Rest of the World Excluding Japan	Canada	West Germany	United Kingdom	Italy	France
1960	298	5,268	909	378	494	322	303
1965	−333	6,446	811	308	210	272	355
1967	−303	5,017	58	−250	250	117	334
1968	−1,100	2,509	−933	−1,013	230	19	253
1969	−1,399	3,362	−1,246	−461	214	58	353
1970	−1,223	4,486	−2,008	−389	341	36	542
1971	−3,207	1,706	−2,426	−820	−85	−92	294

Source: Bank of Japan, "Nichibei bōeki no chōkiteki dōkō" [Long-term trend of Japan-U.S. trade], *Chōsa geppō*, October 1972.

TABLE VIII

COUNTRIES CONTRIBUTING TO THE DETERIORATION OF THE U.S. BALANCE OF TRADE

($ million)

	U.S. Trade Balance in 1964	U.S. Trade Balance in 1971	Net Deterioration of U.S. Trade Balance	Share of Contribution (%)
Japan	241	−3,207	3,448	37.0
Canada	676	−2,426	3,102	33.3
West Germany	435	−820	1,255	13.5
United Kingdom	389	−85	474	5.1
Italy	425	−92	517	5.5
France	499	294	205	2.2
Others	5,159	4,835	324	3.5
Total	7,824	−1,501	9,325	100.0

Source: See Table VII.

in its balance vis-à-vis Japan, the deficit in which balance was nearly four times as large as the U.S. deficit with West Germany in 1971, the year of the multilateral currency realignment. The percentage contribution to the deterioration of the U.S. trade balance by Japan considerably surpasses that by West Germany.

C. *Undervaluation of the Yen*

Japan's balance of payments before the 1971 revaluation of its currency was in surplus-biased disequilibrium with an excessive surplus on trade account with the United States. Major reasons for this external disequilibrium of Japan are explained above, but another very significant reason is found in the change in the position of the Japanese yen in the international exchange rate system. The yen was becoming progressively more undervalued as the balance-of-payments surplus increased. Thus, the Japanese economy was obviously in a state of fundamental disequilibrium. There are various definitions of the concept of fundamental disequilibrium, but I would like to use one of my own, which is largely in agreement with Harrod's concept. Thus, fundamental disequilibrium is a state in which price and production cost structures are completely isolated from the external value of the yen, or, in other words, the state where the exchange rate of 360 yen per dollar had already been an undeniable undervaluation. However, the fundamental disequilibrium of the Japanese economy does not mean only a state in which the Japanese economy gradually increased its competitive power in international trade. In the Japanese economy, which has a continuing large balance-of-payments current account surplus, and yet is placed under various minute, extensive, and rigid import and payments restrictions, as mentioned above, no effective adjustment could possibly take place.

The government's eight-point program for averting revaluation of the yen in June 1971, or similar attempts will never prove useful to meet the imminent challenge of the approaching revaluation, which is in fact unavoidable, although such policies may be effective in the long run. If such an adjustment process is followed artificially, a rampant inflation will certainly be generated in the domestic economy, even though fundamental disequilibrium may be dissolved. Those who have come to understand the current situation of the Japanese economy have begun to advocate an early realization of the upward revaluation of the yen. I myself am one of these people, and I advocated an early and unilateral revaluation of the yen at the beginning of 1970 when the yen was clearly undervalued. My opinion was as summarized in the following: For the Japanese economy it was already time to shift from orientation to inflationary growth to policies directed toward stabilization; excessive exports are nothing but the squandering of resources; the Japanese economy has grown mighty enough to make due contribution toward the maintenance and expansion of international interests, and therefore failure to do so would invite foreign countries to institute and reinforce direct restrictions on their imports from Japan, which eventually would impair even orderly exports of Japan; furthermore, the United States (deterioration of whose balance of payments was widely attributed to excessive imports from Japan) and Western European countries were beginning to be very much concerned about the flood-like deluge of aggressive exports from Japan, so that it was feared that they would sooner or later begin to apply forceful restrictions against Japan.

In opposition to this argument, those who were against the yen revaluation were asserting the following: The Japanese economy was not in a situation to be deemed as fundamental disequilibrium as yet; therefore, the yen was not undervalued; the major reason for the balance-of-payments surplus was the stimulative effect of the so-called forced exports evolved in the stagnancy of domestic demand for plant and equipment investment and of imports, as a result of the enforcement of the stringent monetary policy of the Bank of Japan, consequently, it was still possible to generate adjustment artificially and purposely; the eight-point program, which was designed primarily to liberalize trade and capital transactions, was considered to possess powers assuredly adequate to avoid yen revaluation; revaluation of the yen would only give rise to another revaluation subsequently, and a much better policy for the acceleration of imports would be promotion of structural reform of the Japanese economy, and in particular reform of the existing import structure which was almost exclusively centering around raw material imports and very limited imports of consumer goods; and at any rate it is unbearable to sacrifice national interests for the sake of protecting and expanding international interests.

These negative reactions, rejecting such an unheard of event as an upward change in the exchange rate (which had never been recorded in Japan's economic history), were accepted by the majority of the people in those days, but, nevertheless, the objective conditions requiring a revaluation of the yen were becoming progressively stronger. These conditions culminated in a huge amount of selling of U.S. dollars to Japan by both the Japanese and foreigners who realized that revaluation of the yen was unavoidable, sooner or later. A large number of leads and lags in exchange transactions began to take place. The Japanese monetary authorities were buying dollars that flowed into Japan at the IMF par value in support of the rate of exchange, thereby substantially adding to Japan's holdings of dollars, which were one of the most important indicators of the mounting pressure for upward revaluation of the yen. Finally, revaluation of the yen was carried out as part of the multilateral currency realignment, by 16.88 per cent, the highest change in exchange rates at the Smithsonian Conference.

It should be recognized that there are many lessons we must learn from the last revaluation of the yen. Most of these lessons have been referred to above, but above all, the following two points should be noted here again. One is the folly of superficially presenting the problem in an alternative formulation—revaluation of the yen versus liberalization of trade and capital transactions. The possible and feasible policy measures should have not been considered as mutually exclusive; these two measures are both feasible concurrently, and both still need to be implemented. Revaluation of the yen was considered indispensable as a complementary measure to liberalization of trade and capital transactions. It is readily conceivable that, even when yen revaluation is carried out, increase in imports and capital exports will not be attained if various restrictions on trade and exchange are not relaxed. Also relaxation of various trade restrictions would not be effective to cause a change in the existing pattern of Japanese trade—artificially enlarged exports and depressed imports—if the excessive undervaluation of the yen were not corrected. Furthermore, as mentioned earlier, due consideration was not given to the fact that all these measures could not be expected to become effective in time to prevent yen revaluation, although they might be useful in moderating the mounting surplus in the balance of payments.

The second lesson concerns the mistake of the Japanese in both the government and private sectors of forgetting the significance of protecting and expanding international interests, as already mentioned. Harmonization of international and national interests is possible. However, the attitude of government, as well as business circles in Japan, seemed to be negative toward international cooperation throughout the whole period of negotiation following the Nixon shock, putting emphasis on national interests and profits first. The lack of positive initiatives from the Japanese side contributed to the development of a situation in which the final decisions on the magnitude and timing of the 1971 yen revaluation passed out of the control of the Japanese authorities, resulting in a defeatist attitude toward the revaluation. Japan should have taken a more positive stance in seeking solutions which would have contributed to both further international cooperation and Japanese interests.

IV. THE OUTLOOK FOR FUTURE REVALUATION OF THE YEN

Economic Survey of Japan, 1971–1972 was published in the early autumn of 1972, too early for the full effects of the 1971 yen revaluation to have been realized [2]. However, it contains an interesting analysis for considering the probable future course of the yen. First, the survey assesses the effects on the balance of payments as follows:

> Let us next examine how the floating of the yen in August and the multilateral currency realignment in December of 1971 affected this country's payments balance. As for the trade account, it is not yet clear whether they had had a major impact. Their effects, however, began to make themselves felt on the trade account after March, 1972. More recent readings of export and import indicators showed that the upward revaluation would gradually affect Japan's trade balance.
>
> On the other hand, the revaluation had a fairly clear impact on capital accounts. . . . In the long-term capital account, both outward portfolio and direct investment showed an upward trend since the second half of fiscal 1971, partly due to the liberalization of investment in foreign securities. [2, p. 69]

Second, with regard to the influence on the international competitive power of Japanese industry, the survey compares the estimated wage costs in Japan and the United States for 1963 and 1970, and estimates the effects of the 1971 revaluation.

> Japan has gained a relative advantage of more than 10 per cent in terms of wage cost during the seven years, while inflation accelerated in the United States. The industry-to-industry picture shows the wage cost deteriorated in food, textiles, paper and pulp lines, but major gains were made in Japan's mainstay export lines, including steel, electric machinery and transportation machinery. In this sense, the impact of yen revaluation is considered to have been such as can be absorbed adequately by principal Japanese export industries in light of their competitive strength, although the revaluation—as it was one of major magnitude and carried out in one stroke—dealt not a small shock to all industries temporarily and serious setbacks to some of them. [2, pp. 74–76]

These analyses clearly show that the strong and massive industrial capital of Japan, excluding the smaller businesses which have been managing only on the basis of their traditional low wages, is considered to have well endured the trial of the revaluation of the yen. Furthermore, there is other significant evidence which underlines the fact that Japanese industry has already been emerging successfully from the influence of the revaluation of the yen, at least in a macroscopic viewpoint. This is shown by the recent trend in the leading indicators of the Japanese exports (e.g., the number of trade negotiations, received letters of credit and signed export contracts), especially those of exports to the United States.

In the discussions now going on about the position of the yen, there are again two controversial opinions which are directly opposite to each other, namely, pro- and con-revaluation. Views of those who are on the negative side seem to be based on the following ideas: Another revaluation will deal a fatal blow to Japanese industry which has not adequately recovered from the severe injury suffered from the last revaluation; another revaluation will only be a cause for further revaluations—it cannot be a decisive, effective measure to establish external equilibrium for Japan; preferable is a structural reformation of industry that will enable Japan to avert a second revaluation of its currency; and if basic Japanese economic policy aims at exhaustively pursuing national welfare, the present substantial accumulation of balance-of-payments surpluses will be dissolved by collectively investing in domestic capital to this end. These suppositions for arguing the negative position remain unchanged from prior to the 1971 revaluation of the yen, they do not represent any of the precious lessons which we have learnt at very high cost from that revaluation. Thus, these ideas are not convincing as a basis of opposition to the necessity of a second revaluation of the yen.

In this connection, I must propose the discussion on an important fundamental problem, that is, the question whether it is appropriate to be preoccupied with the mutually exclusive consideration of "the revaluation of the yen versus the enhancement of national welfare." Cognition of the problem in that way is itself a basic mistake. The revaluation of the yen is no more than a policy of very minor significance as compared to the policy of national welfare. Welfare policy must be pursued by means of overall policy measures, among which the yen problem will be included as one; it is not a matter of an alternative choice of policy.

POSTSCRIPT

Since this paper was written, another monetary crisis has plagued the world economy. Facing the heavy currency speculation which first broke out in Europe and the subsequent devaluation of the U.S. dollar, Japan has floated the yen. It is difficult at this point to predict the definite course countries of the world may take to resolve the current unrest, or what type of international monetary structure will eventually emerge from the situation. Nevertheless, there seem to be three possible outcomes when the situation is viewed with reference to the theme of this paper.

First, the countries may return to fixed exchange rates, possibly as a temporary measure. This would constitute a continuation of the Smithsonian monetary structure, or central rates arrangement. The dollar probably would remain the key currency even though no steps were taken to restore the credibility of that currency. The margin of fluctuation allowed by the Smithsonian agreement would have to be modified upward from the previous 2.25 per cent to 4 or 5 per cent on both sides of the central rates.

The second possibility is for the nations to actively intervene in exchange markets to arbitrarily set exchange rates. A possible result could be an "exchange war" similar to the one experienced in 1930s. The likelihood of such an unhappy development would be slight, in my opinion, as the countries should have surely learnt from the lessons of the thirties that such competitive intervention is as detrimental to each country's national economy as to international trade.

Third, the United States and the EC countries may form two independent monetary blocs. Unable to join either, Japan may be left an orphan, or outcast, of the world economy, the least desirable situation for this country.

Of the three possibilities, the first course seems most promising. The maintenance of the central rates structure is the one most practicable for the world as a whole and for Japan. However, this country would have to pay a price in the form of another yen revaluation. If nationalist tendencies gain strength and bloc countries float their currencies against outside currencies with only bloc interests in mind, the result will be a disaster for world trade and the flow of overseas investments. Thus Japan must play a firm role in protecting the free, multilateral, and nondiscriminatory world monetary structure. From this viewpoint, and considering the position of the yen in the international monetary structure, Japan should be ready to take flexible corrective measures when the currency is undervalued, or overvalued.

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