Yoshiko Kojo. "Japan's Changing Attitude toward Adjusting Its Current Account Surplus: The Strong Yen and Macroeconomic Policy in the 1990s." In *New Perspectives on US-Japan Relations*, edited by Gerald L. Curtis. Tokyo and New York: Japan Center for International Exchange, December 2000, 146–174.

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Japan's Changing Attitude toward Adjusting Its Current Account Surplus:

The Strong Yen and Macroeconomic Policy in the 1990s

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SINCE THE LATE 1960S, imbalances in countries' external balance of payments positions have been an important item on the agenda of trade talks among industrial states. Specifically, the problem of current account imbalances—in particular, the large U.S. external deficit and Japan's large external surplus—has been a major issue in U.S.-Japan relations since the 1970s. The United States first started to experience a current account deficit in the 1970s, and has seen widening deficits since the 1980s. In contrast, Japan showed a current account surplus throughout most of the 1970s, and that surplus expanded rapidly from the mid-1980s on (see table 1). Every time Japan showed a large current account surplus, the U.S. government strongly pressed the Japanese government to eliminate the imbalance by applying macroeconomic policy, and particularly fiscal policy. The U.S. political pressure was based on the claim that there should be international coordination of domestic economic policies, and that industrial states—especially the United States, Germany, and Japan—should coordinate their domestic policies in order to reduce their external imbalances and related tensions.

In reality, however, this type of international coordination is difficult to achieve, mainly because few states are willing to alter their domestic policies solely for the purpose of adjusting external current account imbalances. Both economic and political considerations dictate that this be so (Gilpin 1987, 378-379). Macroeconomic policies, including monetary and fiscal policy, are traditionally formulated to achieve such domestic economic objectives as adequate growth, price stability, and full employment. It is therefore difficult for a state to alter its existing macroeconomic policy for the sake of external goals—in other words, adjusting the current account imbalance at the expense of domestic objectives—without provoking a domestic debate on the appropriateness of the state's policy choice.

Table 1. Balance of Payments: Japan and the United States 1970–1995 (US$ billions)

	Current Account Balance		Overall Trade Balance	
	Japan	United States	Japan	United States
1970	1.99	2.62	3.96	2.59
1971	5.80	-0.98	7.76	-2.27
1972	6.64	-5.26	8.94	-6.42
1973	-0.13	7.58	3.64	0.91
1974	-4.72	1.70	1.35	-5.51
1975	-0.68	17.88	4.94	8.91
1976	3.71	3.84	9.80	-9.49
1977	10.91	-15.10	17.16	-31.10
1978	16.53	-15.77	24.30	-33.95
1979	-8.74	-0.13	1.74	-27.54
1980	-10.75	2.15	2.13	-25.51
1981	4.77	4.84	19.96	-28.02
1982	6.85	-11.60	18.08	-36.48
1983	20.80	-44.22	31.46	-67.09
1984	35.00	-99.01	44.26	-112.48
1985	51.13	-124.47	55.99	-122.18
1986	85.88	-150.49	91.19	-145.05
1987	84.35	-166.47	91.58	-159.56
1988	79.25	-127.71	92.24	-126.96
1989	63.21	-104.26	80.12	-115.14
1990	44.08	-94.26	69.28	-109.03
1991	68.20	-9.26	96.08	-74.07
1992	112.57	-61.36	124.76	-96.10
1993	131.64	-90.57	139.42	-130.72
1994	130.26	-132.93	144.19	-164.14
1995	111.04	-129.19	131.79	-171.69

Source: International Monetary Fund (1998).

Indeed, this complex challenge facing states—the need to balance domestic objectives with the adjustment of international imbalances, is what Gilpin has termed the "clash between economic interdependence and political autonomy" (1987, 167).

In light of the constraints on altering domestic policy, under what circumstances might a state nevertheless decide to apply macroeconomic policy for the purpose of adjusting its external imbalances? Answering this question should prove helpful for evaluating the possibility of international macroeconomic coordination.

The cases of Japan in the 1970s and the 1980s are instructive for this purpose. More than any other industrial state in the post-World War II period, Japan chose to apply macroeconomic policy to adjust its balance of payments when it was faced with current account surpluses, even though the country was experiencing a budget deficit problem during that period. Since Japan was often regarded as one of the most stubborn states, resisting changes to its domestic policy in areas such as market liberalization even in the face of strong U.S. pressure, one wonders why Japan was more responsive to similar pressures to adjust its current account imbalance.

There were four time periods during which the Japanese government was pressed hard by the U.S. government to eliminate its current account surpluses by applying yen appreciation, macroeconomic policy, or a combination of the two: (a) 1971–1973, (b) 1977–1978, (c) 1985–1987, and (d) 1993–1995. In the first three cases, Japan was more willing to modify its fiscal policy to adjust its large current account surpluses—as was requested particularly by the United States—than was Germany, which was also under U.S. political pressure and which had a lower budget deficit and higher unemployment rate than Japan (Kojō 1996). However, by the early 1990s, Japan had become reluctant to pursue external surplus adjustments through fiscal policy. How can we explain this shift?

In a previous study I conducted of the first three cases, I concluded that domestic-level factors mattered more in Japan's policy choice of adjusting external surpluses than traditional approaches have assumed (Kojō 1995; 1996). In particular, I found that two domestic-level factors were important variables in understanding the state's choice of adjusting external imbalances. The first factor was domestic preferences regarding the exchange rate. The second factor was the domestic political structure that affected the formulation of national policy on the issue of adjusting the current account surplus.

From the late 1980s on, however, dramatic changes occurred in Japan's economic environment. Following the conclusion of the Plaza Accord in 1985, international capital mobility increased and the value of the yen rose, hitting a record high level in 1995. The Japanese economy recorded a 5 percent growth rate from 1987 to 1991. However, in 1993 the bubble burst, sending the Japanese economy into a prolonged recession. As a result, Japanese industry was forced to undertake structural changes in order to cope with both economic internationalization and the turmoil of the domestic economy.

How did these changes affect Japan's policy choices regarding the adjustment of its current account surplus? Did these economic changes alter the domestic preferences regarding specific policy instruments? The purpose of this chapter is, first, to explain the domestic sources of Japan's policy choices, and, second, to examine how changes in the international and domestic economic environment affected domestic preferences and state policy choices in the 1990s. The chapter is comprised of three parts. The first section will explain why eliminating current account imbalances has been an important issue in U.S.- Japan bilateral relations since the late 1960s and will summarize the policy choices that have been made in response to concerns over large external surpluses. The second section will examine the importance of domestic-level factors in explaining Japan's policy choices in the 1970s and the 1980s. And finally, the third section will analyze the case of the early 1990s by focusing on how domestic preferences regarding policy instruments for adjusting external surpluses changed as economic interdependence deepened from the mid-1980s on.

The Problem of Current Account Surpluses

Balance of Payments Adjustment as a Political Agenda

During both the gold standard era and the Bretton Woods era of the fixed exchange rate system, there was a framework or norm for making adjustments to the balance of payments. States experiencing unsustainable external imbalances were expected to eliminate those imbalances by modifying their own policies (Simmons 1994; Obstfeld 1993). In the floating exchange rate system of the post–Bretton Woods period, by contrast, no consensus has emerged among states on the degree to which imbalances should be adjusted. Many economists claim that it is not necessary to eliminate external imbalances because the imbalances in and of themselves are not detrimental to international economic welfare (Komiya 1993, 59; Krugman 1994, 44–48). Despite the attempts by a number of economists to define optimal policy choices, there is no single economic model that spells out how much external payment imbalances should be adjusted and under what circumstances states should apply various policy instruments.[1] As a result, since the early 1970s states faced with external payments imbalances tend to want other states to take responsibility for changing their policies and eliminating the imbalance. Individual states have not paid serious heed to calls to adjust their current account imbalances unless those imbalances seemed incompatible with their own economic objectives or undermined the international economy as a whole.

Despite the fact that there is no consensus among economists on the necessity of adjusting current account imbalances, however, the issue has been high on the international political agenda since the late 1970s. There were two phenomena that particularly attracted the attention of the international community during this period. One was the external debt of developing countries, which had become a serious problem even before being brought to the forefront by the Mexican crisis of 1982. The second phenomenon was the emergence of a large U.S. current account deficit, coupled with large current account surpluses on the part of Japan and pre-unification West Germany. Among industrial states—and particularly between Japan and the United States—the persistent imbalance of current accounts has been a cause of political disputes. The accumulation by the United

States of a huge current account deficit was attributed by many in the United States to Japan's large current account surplus, giving rise to protectionist arguments. Many in the United States claimed that since the U.S. trade deficit with Japan was a major cause of the U.S. current account deficit, Japan should eliminate its current account surplus, including its trade surplus, as a way of contributing to the reduction of the U.S. current account deficit.

In the four time periods I have listed above, the United States played a major role in placing international balance of payments adjustment on the political agenda among industrial countries, and in demanding that Japan and Germany use particular policy instruments. The first time period was 1971–1973, following the Nixon Shock. Until the late 1960s, Japan had experienced a cyclical external payment deficit. In 1968, however, that deficit turned into a surplus that continued to grow thereafter. In 1971, Japan posted a large current account surplus, while the United States was facing a significant external deficit compared to previous years. After the Nixon Shock, neither the temporary floating system nor the multilateral currency adjustments agreed upon by the Group of Five (G5) members could adjust the imbalances. In order to stabilize international monetary relations, international organizations such as the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) proposed adjusting the international balance of payments imbalances, and the Japanese government was pressed hard by the international community to revalue the yen in order to cut its surplus.

During the period 1977–1978, the U.S. government urged the German and Japanese governments to apply macroeconomic policies to eliminate their current account surpluses, advocating a "locomotive theory" in which the expansion of the American, German, and Japanese economies would provide benefits for other nations. In the aftermath of the oil shock, these three countries were recovering from severe cost-push inflationary pressures and showed current account surpluses, while other industrial states such as Britain, France, and Italy still suffered from current account deficits. The unevenness of these current account balances among industrial states was recognized as a problem in the international economy and adjusting these imbalances topped the central agendas of international organizations, prompted mainly by the United States. The U.S. government's eagerness for adjustments was related to its concern over the country's changing external payments position. As it became more and more apparent that its current account balance was worsening, the U.S. government began to criticize Japan and Germany—the two countries running surpluses—for not taking appropriate measures to eliminate those surpluses. The U.S. government also emphasized the relationship between exchange-rate misalignment and its own external deficit, and pushed the Japanese and German governments to appreciate their currencies.

During the 1980s, the problem of balance of payments adjustment again became one of the most urgent issues confronting the international economy. The aggregate current account deficits of the OECD countries as a whole declined in 1981 but rose again to US$61 billion in 1984. External payment imbalances among industrial countries became prominent—particularly the large current account deficit of the United States and the increasing current account surpluses of Japan and Germany. As it became apparent that exchange-rate movements for major currencies were heading in a direction that would further widen these imbalances instead of eliminating them, a strong dollar and high U.S. interest rates provoked political debates internationally over the appropriateness of U.S. macroeconomic and exchange-rate policies in terms of the country's balance of payments.

In 1985, the U.S. government finally acknowledged the links among its budget deficit, a strong dollar, and its external deficit, and placed exchange rates and macroeconomic policies on the international agenda. The U.S. government once again asked the Japanese and German governments to adopt expansionary macroeconomic policies in order to adjust their external surpluses, which would reduce the U.S. external deficit.

During the period 1993–1995, the U.S. government also pressed the Japanese government to apply macroeconomic policy, calling in particular for tax cuts and increased public works spending to eliminate Japan's record-high current account surplus. Since the U.S. trade deficit with Japan had increased, the U.S. government was also eager to reduce Japan's current account surplus by pursuing aggressive bilateral trade talks with Japan, such as the Framework Talks.

In all four of these cases, the Japanese government was under political pressure from the United States to reduce its current account surpluses. However, the Japanese government did not have to eliminate its surpluses by applying macroeconomic policy, as was demanded by the U.S. government. Why, then, did the Japanese government decide to respond to the U.S. request and to apply fiscal policy to adjust the current account imbalance?

Policy Instruments for Reducing Current Account Surpluses

In order to understand the rationale for a state's choice of a particular policy instrument, it is first necessary to examine the alternatives available for shifting the current account position. The primary policy options can be divided into three categories.[2] The first category is direct control of international trade and capital transactions at national borders. Through the use of such measures as special taxes, tariffs, and quotas, deficit countries can restrict capital outflows and imports of merchandise and services, while surplus countries can restrict capital inflows and exports. The second category is exchange-rate policy. It is assumed that appreciation will reduce current account surpluses and depreciation will eliminate deficits (Bergsten and Noland 1993). Under a floating exchange rate system, the foreign exchange market mechanism was assumed to reduce current account imbalances automatically. However, after it became apparent that such automatic adjustments were not always occurring, exchange-rate policy came to be recognized as a useful policy option. Exchange-rate policy in a floating exchange rate system implies intervention in the foreign exchange markets.[3]

The final category is macroeconomic policy, which is usually used to achieve stable domestic economic conditions. In this area, monetary policy and fiscal policy are considered as useful tools for adjusting external imbalances. However, since monetary and fiscal policies have opposite effects on the capital account, fiscal policy might be directed to internal stability and monetary policy to external stability (Mundell 1962). It is generally believed that a current account deficit may be corrected by a more deflationary macroeconomic policy, while a surplus may be corrected by a somewhat more inflationary policy.

Of these categories of policy instruments, the first option is usually only useful—and thus only applied—for temporary imbalances. The latter two categories are considered as the main policy instruments for correcting persistent large current account imbalances.[4] Facing persistent external imbalances, a state can choose either to change its exchange rate, its macroeconomic policy, or both.

In the 1970s and the 1980s, as we have noted above, the Japanese government ended up applying expansionary fiscal policy (as was urged by the United States) despite its initial reluctance to do so. The question is why Japan consistently subordinated its macroeconomic policy to balance of payments considerations.

Japan's Policy Choices in the 1970s and 1980s

Domestic Anti-Yen Appreciation Preferences

Existing approaches in international political economy to explaining why and how states choose certain policy instruments to make such adjustments tend to emphasize the process of negotiation among or between states (Destler and Mitsuyu 1982; Henning 1987; Funabashi 1989; Iida 1990). There is no doubt that U.S. political pressure played an important role in urging Japan to deal with its current account surplus. However, it is important to know how and through what mechanism the government chose particular policy instruments to accomplish that objective. Choosing a certain policy entails the domestic allocation of the costs and benefits that derive from such a policy choice. Therefore, it can be assumed that there are societal preferences regarding that choice. A typical example is the impact of trade policies such as the lowering of tariff rates, which may cause a diversion of domestic preferences between import-competing industries and export-oriented industries.

The conventional understanding regarding the use of such instruments as exchange rates and macroeconomic policy for the purpose of adjusting current account imbalances is that exchange-rate policy is relatively easy to apply in this instance because changes in exchange rates do not provoke disputes in domestic politics (Kelly 1982; Krasner 1978; Odell 1982; Gowa 1988). By contrast, it is assumed that policymakers are constrained in the use of macroeconomic policy by domestic political pressures, since as noted above, the primary concern of macroeconomic policy is generally the domestic economy and objectives. Fiscal policy, in particular, is difficult to change for the purpose of adjusting a country's external payment position because it needs to be authorized by the legislature (Buchanan and Wagner 1977). The corollary usually drawn from this is that a state faced with the need to make such adjustments is likely to apply exchange-rate policy and to resist changing its macroeconomic policy. However, this corollary does not explain Japan's policy choices in the 1970s and the 1980s, when Japan tended to apply expansionary fiscal policy to adjust its balance of payments.

Since conventional explanations have tended to be based only on U.S. cases, they have missed the importance of domestic preferences. Recent studies, however, shed light on the significant role that domestic preferences play in regard to changes in exchange rates (Frieden 1991; Henning 1994). According to these economic models, changes in the exchange rate will result in costs and benefits for certain societal groups. Tradable sectors (i.e., export-oriented industries) are likely to be against the appreciation of currency, since it would undermine the competitiveness of exports. Industries that rely on imported intermediate products and raw materials, on the other hand, are more likely to be in favor of currency appreciation because the price levels of imported materials would be lowered. For the same reason, import-competing industries will generally be opposed to currency appreciation. A non-tradable sector like international banking would probably be for currency appreciation or volatility of exchange rates, since it can take advantage of those trends. Consumers also might be for currency appreciation, because appreciation stabilizes price levels by reducing the cost of imports (Frieden 1991, 444–449).

When Japan began to face both a stronger yen and an external surplus in the 1970s and 1980s, domestic preferences were predominantly against the appreciation of the yen and for fiscal expansion. As the yen appreciated, expansionary macroeconomic policy came to be focused on counter-*endaka* (strong yen, or yen appreciation) and counter-recessionary measures. Japan's export-oriented industries and small and medium-sized businesses were especially sensitive to exchange-rate levels and pressed the government to stop the acceleration of the yen's rise by applying fiscal expansion. In contrast, sectors of society that were expected to benefit from *endaka*, such as importing industries, service industries, and consumers, rarely voiced their preferences. Given that Japan's export dependence in the 1970s and 1980s was smaller than that of every other industrial state except for the United States, it seems puzzling that the negative effects of yen appreciation were emphasized and not the positive effects (see table 2).

Two factors are critical to explaining this puzzle. The first is the influential position held by Japan's export-oriented industries. Since the 1950s, export-oriented industries were regarded as essential for Japan's domestic economy. In the post–World War II period, and up until the mid-1980s, the Japanese government's economic policy emphasized export-led growth. The growth rate of exports during the 1960s was 16.9 percent, which was much larger than the average rate of 9.5 percent for all industrial states, although Japan's export dependence ratio was smaller than most industrial states in 1970. The growth rate of exports was highest in export-oriented industries such as steel, electronic products, textiles, and automobiles (Ishizaki 1990). Export-oriented industries organized politically influential industrial associations and were powerful members of peak business organizations.

Second, export-oriented small and medium-sized manufacturers were especially active in lobbying political parties and the government on exchange-rate policy (Kojō 1995). Since exports represented a larger percentage of their business than that of big enterprises, the export-oriented small and medium-sized enterprises were expected to be hit severely by the yen's appreciation.[5] Also, since more than 80 percent of the workforce was employed by small and medium-sized enterprises in the 1970s and 1980s, the associations of these businesses were able to voice their fears regarding the negative impact of *endaka* on not only their own jobs but also the Japanese labor market as a whole.

Table 2. Export Dependence of Germany, Japan, and the United States, 1965–1997 (percentage of exports in GDP)

	Germany	Japan	United States
1975	—	12.8	8.4
1976	—	13.6	8.2
1977	—	13.1	7.8
1978	25.7	11.1	8.1
1979	25.2	11.6	8.9
1980	26.4	13.7	10.0
1981	28.7	14.7	9.7
1982	29.8	14.6	8.7
1983	28.7	13.9	7.9
1984	30.7	14.5	7.8
1985	32.6	14.5	7.2
1986	30.2	11.4	7.3
1987	28.9	10.4	7.8
1988	29.5	10.0	8.9
1989	31.6	10.6	9.4
1990	32.3	10.7	9.7
1991	25.4	10.2	10.2
1992	23.7	10.1	10.2
1993	22.1	9.3	10.0
1994	22.7	9.3	10.4
1995	23.0	9.4	11.3
1996	23.3	9.9	11.4
1997	25.3	11.1	11.9

Source: International Monetary Fund (1999).

Political Institutions: Responding to Domestic Preferences

Although there was clearly a predominant domestic preference against *endaka* in Japan, the ability of such preferences to affect a state's policy choice in terms of adjusting the balance of payments depends on the existing political institutions and the degree to which domestic preferences are reflected in the policy-making process (Garrett and Lange 1995; Frieden and Rogowski 1996).

The relationship between the bureaucracy and political parties plays an important role in determining policy in this area. Government officials generally prefer to form policy decisions autonomously from domestic political pressures, while political parties usually reflect domestic preferences in their policy choices. In macroeconomic policy, there is a common assumption that government officials and political parties have different interests. Whereas political parties tend to be more concerned with employment and economic growth, the financial ministry is usually much more concerned with balanced budgets, and the central bank is more concerned with stable price levels (Paterson and Rom 1988; Wildavsky 1984; Buchanan and Wagner 1977). In monetary policy, the independence of the central bank from political pressure is regarded as a significant determinant (Wooley 1985; Goodman 1992; Henning 1994). If the central bank is independent, monetary policy tends to be more price stability–oriented. In terms of fiscal policy, the financial ministry is usually reluctant to apply expansionary policy, while political parties are more likely to support such measures. In contrast, exchange-rate policy is usually regarded as being autonomous from political pressures because the exchange rate is so technical that only a limited number of government officials can formulate policy (Krasner, 1978; Odell 1982; Gowa 1988).

In Japan's case, there were two institutional characteristics that affected the issue of exchange-rate and macroeconomic policies. First, the country's central bank, the Bank of Japan (BOJ), was much less independent than the central banks of Germany or the United States in terms of influence from the financial ministry (Henning 1994). In the area of monetary policy, it was difficult for the BOJ to resist political pressure. Second, since the 1960s the Liberal Democratic Party (LDP), which was in power from 1955 through 1993, and other parties as well responded favorably to the preferences of export-oriented industries, and to those of export-oriented small and medium-sized enterprises in particular. The reason was that, since export-oriented small and medium-sized enterprises were essentially local businesses, they represented a significant share of the electoral bases of the political parties—both of the LDP and the opposition parties (Hiwatari 1991, 79–86; Calder 1988, 334).[6] As a result, small and medium-sized business policy has been one of the few issue areas with a low degree of partisan conflict since the 1960s (Mochizuki 1982, 333–334). Since all political parties in

Japan shared an interest in export-oriented small and medium-sized businesses, they also held a common stance on the appropriate policy instrument for balance of payments adjustment. As a result, the political parties succeeded in influencing policy formulation despite the fact that their preferences differed from the policy preferences of the BOJ and the Ministry of Finance (MOF). As the yen appreciated, the political parties tended to emphasize the negative effects of the strong yen and pressed for fiscal expansion as a means of curbing further appreciation.

The Cases

1971–1973

As noted above, Japan was faced with the problem of adjusting its external payments surplus in the 1970s and the 1980s. In December 1971, after the Nixon Shock, the cabinet of Prime Minister Satō Eisaku was forced to revalue the yen—an action Japan had long sought to avoid—under the terms of the Smithsonian Agreement, an agreement on multilateral currency realignment reached among the G5 nations at the Smithsonian Institution in Washington, D.C. The rate of revaluation, 16.88 percent, was the largest among the industrial countries. The following year, however, the Japanese government was faced with international political pressure to allow the yen to appreciate still further due to its continuing external payments surplus, and officials of MOF and the BOJ came to realize that Japan would have to accept a further revaluation. However, export-oriented industries, including small and medium-sized businesses, aggressively opposed any further strengthening of the yen.

In response to these domestic interests, political parties—all of which shared the same anti-revaluation preference—had an interest in provoking a political debate over the appropriate policy instruments for avoiding a further revaluation. The opposition parties blamed the LDP government for failing to avoid the revaluation of the yen. As a result, the government's policy choices were restrained and, in an effort to avoid revaluation, the government ended up relying heavily on expansionary macroeconomic policy to make the necessary adjustments to the balance of payments (Nakagawa 1981). In 1972, although the domestic economy had begun recovering and wholesale prices had been rising after the summer, the cabinet of Tanaka Kakuei (who had succeeded Satō) did not reconsider expansionary policy (Nakagawa 1981). Fiscal expansion in particular proved to be a policy instrument that was compatible with domestic preferences against *endaka*.[7]

1977–1978

In 1976, as it became increasingly apparent that the U.S. current account balance was worsening, the administration under President Jimmy Carter began to criticize Germany and Japan for not taking appropriate measures to eliminate their surpluses. At that time, the United States asked the Japanese and German governments to apply expansionary macroeconomic policy to their domestic economies.

The emergence of international criticism of Japan's current account surplus sparked a sharp rise in the yen from the end of September 1977. Over the subsequent two months, the value of the yen appreciated by about 10 percent. As the yen gained sharply against the dollar, the opposition to a strong yen became more vocal in the domestic political arena (Volcker and Gyohten 1992, 153). Business organizations and export-oriented small and medium-sized businesses demanded that Prime Minister Fukuda Takeo halt the yen's appreciation by applying expansionary fiscal policy. They responded not to the actual impact of yen appreciation on the economy as a whole, but to the rise in the exchange rate itself and the resulting fear of projected losses that they would incur.

With rapid yen appreciation and an increasing external payment surplus, the Fukuda cabinet was confronted with criticism on two fronts: from the international community, which complained about Japan's failure to stem its mounting surplus, and from domestic industries and political parties, which responded to industry's aversion to the strong yen. Since neither frequent intervention in the foreign exchange market in the autumn of 1977 nor a reduction in the official discount rate that same year appeared effective in preventing further yen appreciation, expansionary fiscal policy became the main focus of political debates (Kojō 1995). The sudden appreciation of the yen from a level of ¥266 to the dollar in September 1977 to a level of ¥240 to the dollar in November of that year strengthened industry's criticism of government policies as being ineffective. Despite MOF's strong opposition to an expansionary fiscal policy, which stemmed from the ministry's concern over the burgeoning budget deficit (the cumulative budget deficit had reached 16.1 percent of gross national product in 1976, up from 8.6 percent in 1974), the Fukuda government finally passed a large supplemental budget for fiscal year 1977, although this did not result in any decrease in the current surplus in 1978, nor did it stem the rise of the yen. In addition, in July 1978, at the Bonn G5 summit, the Fukuda cabinet acknowledged a 7 percent target growth rate (the target had previously been discussed only with the United States).

1985–1987

In the early 1980s, the huge U.S. current account deficit and large current account surpluses of Japan and Germany again became one of the most urgent issues confronting the international economy, as many industrial states (with the exception of the United States) began to fear that the U.S. dollar was overvalued. International negotiations took place continuously regarding which states should choose which policy instruments. At a G5 meeting held at the Plaza Hotel in September 1985, the Japanese government (at that time led by Prime Minister Nakasone Yasuhiro) agreed on exchange-rate realignment as the principal method of adjusting Japan's balance of payments in what is known as the Plaza Accord. As a result of this policy choice, the yen started to appreciate sharply. Between September 1985 and January 1986, the yen rose by about 20 percent, reaching the level of ¥190 to the dollar, which indicates that the Japanese government initially tried to maintain a strong yen to correct its external surplus. This initial policy choice can be explained by the fact that the Nakasone cabinet was firmly committed to a fiscal austerity policy, which was supported by MOF and by business leaders such as Dokō Toshio, chairman of Keidanren (Japan Federation of Economic Organizations).

Due to domestic sensitivity within Japan to the rise in the yen's value, international pressure for expansionary fiscal measures was able to influence Japan's choice of policy measures. In negotiations with the United States, which was concerned with the increasing U.S. trade deficit with Japan, the necessity of exchange-rate stability was accepted by the U.S. government in exchange for Japan's commitment to expansionary macroeconomic policy.

The yen appreciation actually had a number of negative effects on the domestic economy, such as lowering the growth rate and increasing unemployment. Since the yen continuously gained strength, the fear of recession remained strong among export-oriented industries. The Nakasone government did not begin to apply substantive fiscal measures for twenty months after the yen started to appreciate. Monetary policy was the main macroeconomic policy instrument used during this period to deal with external payments adjustment. The Nakasone government tried to avoid applying fiscal expansion, even while the economic slowdown was apparent. Moreover, the divergent views among business leaders on whether more expansionary fiscal policy was needed allowed the government to stimulate the economy through policy measures of privatization and deregulation.

In May 1987, however, the Nakasone government finally decided to introduce a fiscal stimulative package of more than ¥6 trillion, despite the negative impact of such a move on the budget deficit. This decision was a result of domestic preferences, especially those of small and medium-sized exporting businesses, which after January 1987 were increasingly against rapid appreciation of the yen. But by late in the spring of 1987, the domestic economy was already in the process of recovering, and thus, from the viewpoint of the domestic economy, the decision was made too late.

The policy orientations of the anti-Nakasone factions within the LDP and the opposition parties were similar with regard to macroeconomic policy: They were in opposition to MOF's fiscal austerity policy and provoked a debate over the deflationary effect of the strong yen on the domestic economy and its contribution to rising unemployment. They therefore focused on measures to stem the rise of the yen and to compensate small and medium-sized businesses hit by exchange-rate losses. Expansionary fiscal policy, which was urged by the U.S. government as a means of adjusting the current account surplus, was emphasized in domestic politics rather as a way to halt the yen's appreciation and to stimulate the domestic economy. In short, it was as a result of domestic sensitivity in Japan to the rise in the yen's value that international pressure was able to influence the Japanese government's choice of expansionary fiscal policy.

Japan's Policy Choice in the Early 1990s

Upsurges in the Current Account Surplus and U.S. Political Pressure

After 1987, there was a correlation between changes in Japan's overall current account surplus and its trade surplus with the United States on the one hand, and changes in U.S. political pressure on Japan on the other. Since the United States was faced with the problem of large twin deficits—i.e., a large current account deficit and a large budget deficit—the American trade deficit with Japan and Japan's current account surplus raised protectionist sentiments particularly in Congress, which then affected the U.S. government's policy toward Japan. From 1987 to 1990, Japan's current account surplus and its trade surplus with the United States in particular dropped drastically (see table 1). With the decline in external payment imbalances, the related political disputes among industrial states faded away.

In terms of U.S.-Japan relations, the U.S. current account and trade balances with Japan were still showing a deficit, although it was on the decline. The U.S. government continued to ask for Japanese government efforts to adjust those imbalances. In 1989, the administration of President George Bush proposed a new round of bilateral trade talks, termed the Structural Impediments Initiative (SII), in which the U.S. government proposed a new agenda that included a streamlining of the Japanese distribution system and revisions to Japan's Antimonopoly Act. However, until mid-1991, despite the aggressive attitude revealed in SII and other trade talks, the Bush administration took a middle-of-the-road approach to U.S.-Japan relations and did not resort to Super 301, which had been enacted by the Congress in 1988 (Hatakeyama 1996). From 1991 to 1995, as Japan's overall current account surplus and its trade surplus with the United States continuously increased, U.S. political pressure on Japan to reduce its surpluses intensified. In 1995, when Japan's surpluses dropped, the U.S. political pressure subsided.

In 1991, Japan's current account surplus climbed rapidly, jumping to US$42.74 billion in May—three times that registered a year earlier. As this upward trend became apparent, the balance of payments issue once again became a matter of concern to the U.S. government. At the Group of Seven (G7) summit meeting held in October, emphasis was placed on the importance of avoiding the reemergence of very large external payment imbalances. And although the G7 communiqué did not single out any country, it was interpreted as a warning to Japan about its growing surplus (*Nihon Keizai Shimbun* 13 October 1991).

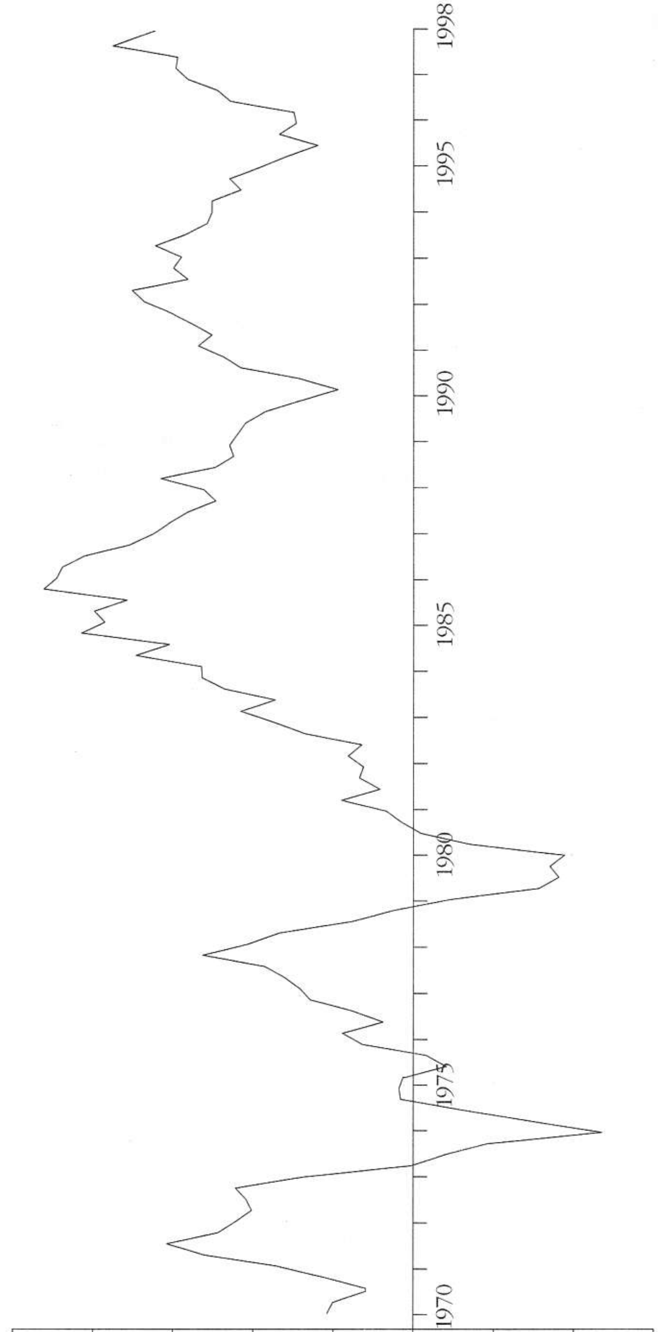
Nonetheless, Japan's current account surplus continued to climb through 1992. In April of that year, economic management in Japan came under fire at a meeting in Washington, D.C., of G7 finance ministers and central bankers. The communiqué once again avoided mentioning Japan directly, but sent an unmistakable signal that Japan should take stimulative policy measures to strengthen its economy and eliminate its external payment imbalances (*Nihon Keizai Shimbun* 27 April 1992). At the same meeting, the U.S. government asked Japan to take expansionary fiscal measures and lower its interest rate. In 1993, Japan's current account surplus grew to a historical high of more than US$130 billion, or 3.3 percent of gross domestic product, jumping from US$44 billion, or 1.1 percent of GDP, in 1990 (see fig. 1). In January of that year, MOF also released trade figures showing that Japan's total overall trade surplus topped US$100 billion for the first time in history. Since the U.S. trade deficit with Japan also expanded, the American government took the initiative to place the problem of Japan's large current account surplus at the top of the agenda for U.S.-Japan relations.

President Bill Clinton, who took office in January 1993, and who gave his full attention to the recovery of the U.S. economy, took a tougher approach toward Japan's current account surplus than had his predecessor. In his first meeting with Minister of Foreign Affairs Watanabe Michio, he clearly stated that Japan's large surplus was a serious problem to be solved between the two countries and that Japan should make efforts to eliminate that imbalance and liberalize its markets (*Nihon Keizai Shimbun* 12 February 1993). The Clinton administration kept pressing the Japanese government (at that time, the cabinet of Prime Minister Miyazawa Kiichi) to undertake macroeconomic policy coordination to eliminate the current account and trade surpluses (*Nihon Keizai Shimbun* 14 April 1993).

In a Clinton-Miyazawa meeting in the spring of 1993, Clinton focused exclusively on the balance of payments problem and proposed two remedies: first, that the yen be further strengthened and, second, that Japan apply expansionary macroeconomic policy. Clinton also suggested to Miyazawa that Japan set a numerical target for the reduction of Japan's current account surplus. Miyazawa, however, refused (*Nihon Keizai Shimbun* 17 April 1993). Three months later, at the G7's Tokyo Summit, the discussions clearly showed that international pressure on Japan to adjust its current account surplus had intensified.

In November 1993, dissatisfied with big spending programs introduced in

Figure 1. Japan's Current Account Balance (percent of nominal GDP)



Source: Bank of Japan

September by the Japanese coalition government of newly installed Prime Minister Hosokawa Morihiro (the first non-LDP prime minister since 1955), the Clinton administration proposed to Hosokawa that his government use a specific policy instrument—namely, the introduction of a large income tax cut—to stimulate the domestic economy (*Nihon Keizai Shimbun* 12 November 1993). The U.S. pressure on Japan for fiscal expansion continued until 1995.

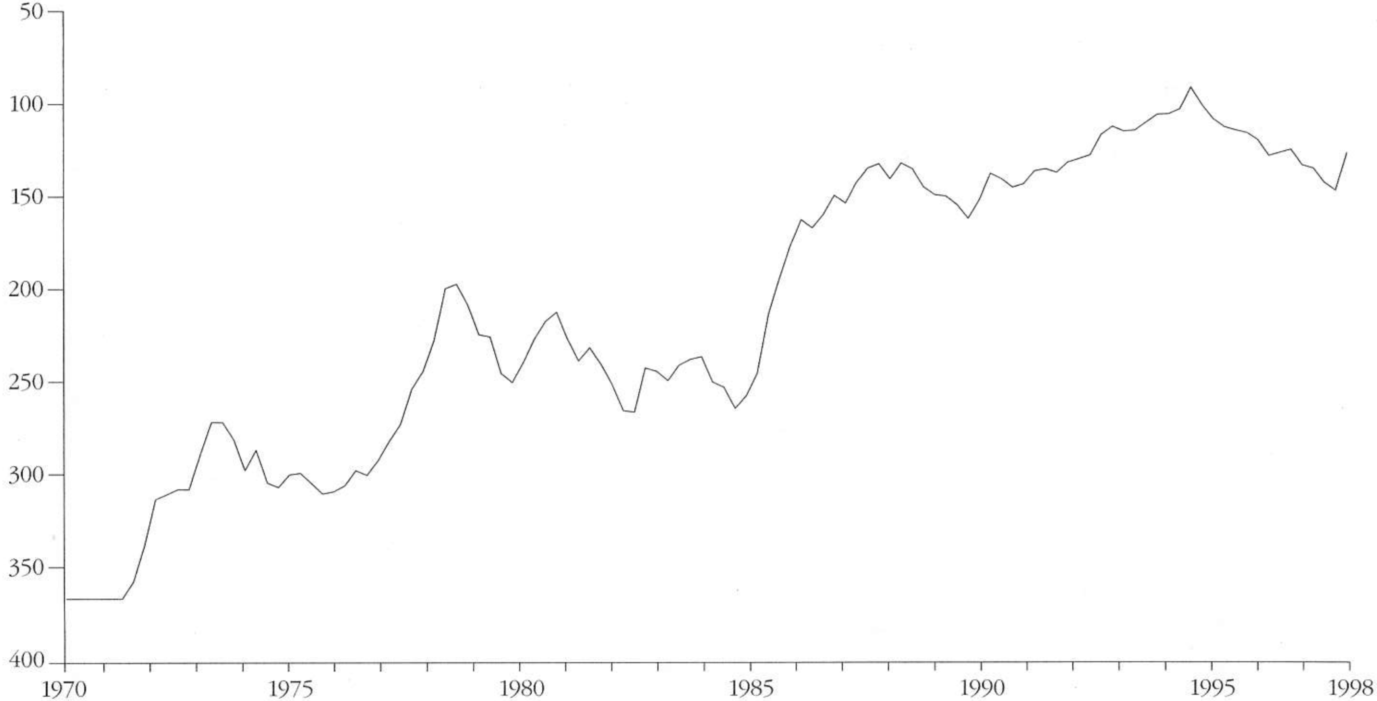
Along with its demand for macroeconomic remedies, the Clinton administration adopted a new strategy for trade talks with Japan that was aimed at reducing its bilateral trade imbalance. The two governments began new trade negotiations, known as the U.S.-Japan Framework Talks on Bilateral Trade, in July 1993. Through these negotiations, the United States attempted to pursue a results-oriented market access strategy, while the Japanese government continued to reject such an approach. Within the context of the Framework Talks, the Clinton administration also proposed once again to set a target of limiting Japan's current account surplus to within 2 percent of GDP, but the Miyazawa government steadfastly refused such an idea because the current account could not be controlled specifically by government intervention. After a Clinton-Hosokawa meeting in February 1994 failed to produce any agreement, the bilateral trade talks were further aggravated by the U.S. government's unilateral trade policies, such as threatening to impose sanctions under Super 301 on a number of Japanese luxury automobiles. (The U.S.-Japan automobile talks concluded the following month, in June 1995.)

The Exchange Rate and Macroeconomic Policies

The yen rate seemed to fluctuate according to changes in Japan's current account surplus in the early 1990s. The yen was undervalued relative to the dollar until the autumn of 1991. At the end of 1991, the yen rate was ¥125.25 = US$1, which was almost exactly the same as the year-end rate in 1988. In the first four months of 1992, the rate stayed close to the ¥133 = US$1 level. In May 1992, the yen started gaining against the dollar and rose steadily through April 1995, although there was some fluctuation during this period. The yen appreciated beyond ¥100 yen to the dollar in June 1994, passed the ¥90 to the dollar mark in March 1995, and hit the level of ¥80 yen to the dollar in April 1995, which was its highest level in the postwar period. It was not until August 1995 that the yen fell back below the level of ¥90 to the dollar (see fig. 2).

In early 1990, when the yen-dollar rate depreciated below ¥155 = US$1, the BOJ expressed concern about a low yen rate, fearing that the lower yen might push up price levels. The BOJ was frequently intervening in the foreign exchange market during that time, sometimes in coordination with the United States, to prevent further depreciation of the yen. The BOJ also raised the discount rate to 5.25

Figure 2. Nominal Foreign Exchange Rates (Yen/$)



Source: Bank of Japan

percent from 4.25 percent in March, and to 6.00 percent in August 1990, in order to stabilize the level of the yen. However, the yen started to appreciate in late 1991, and rose rapidly in early 1993. The new Clinton administration took a more hands-off stance toward the yen-dollar exchange rate than had the Bush administration. The Clinton administration was more eager than the Bush administration to make a political issue of Japan's large current account surplus because of the widening of the U.S.-Japan trade imbalance, which had given rise to domestic protectionist arguments. This hands-off attitude was taken by the Japanese government as a sign of the United States' willingness to apply exchange-rate policy as a form of pressure on Japan to eliminate its current account surplus. Through 1992, the Japanese government also expressed its acceptance of yen appreciation in light of Japan's increasing current account surplus and trade surplus with the United States. In April 1993, however, the BOJ finally intervened in the foreign exchange market by selling yen and buying dollars to avoid further appreciation. This was the first use of this type of BOJ intervention to slow down the yen's rise since December 1988. After April 1993, the BOJ was a lonely player in its effort to stem further appreciation, and its intervention was not effective.

Under U.S. political pressure and foreign exchange market pressure, both of which favored a stronger yen, the Japanese government in the early 1990s had to deal with the problem of balance of payments adjustment in order to avoid further appreciation. After Japan's economic bubble burst, however, the country suffered from a sluggish domestic economy. In this new environment, what policy instruments did the Japanese government have?

Although exchange-rate policy was attempted, it was difficult for the Japanese government to reach an agreement on coordinated intervention among states to reverse the exchange rate moves. This difficulty was revealed at the G7's Naples Summit in July 1994. Prime Minister Murayama Tomiichi, who had been selected the previous month to head a new coalition government of the LDP, the Social Democratic Party of Japan, and the New Party Sakigake, sought to coordinate exchange-rate policy to reverse the yen-dollar exchange rate movement. However, the G7 countries failed to conclude an agreement on this issue. Instead, the final declaration called on countries where economic recoveries were not under way to take expansionary monetary and fiscal policy (*Nihon Keizai Shimbun* 9 July 1994). Although the BOJ continued to intervene frequently to depress the yen's value, for the most part its efforts proved futile.

In terms of applying macroeconomic policy, MOF did not feel that expansionary fiscal measures were feasible during this period. In the 1989–1990 SII talks, the Japanese government had agreed to budget ¥430 trillion for public works spending over the next decade. Despite its pledge, it was difficult for the Japanese government to apply additional expansionary policies. In March 1992, the

Miyazawa administration approved a "Seven-Point Plan" to boost the economy. The measures included front-loading fiscal 1992 public works spending, which would be 15.7 percent higher than the amount initially planned for fiscal 1991. In August, the Miyazawa administration also announced an economic stimulus package, the size of which (¥10.7 trillion) was nearly double the anticipated amount. Despite these packages, however, Japan's current account surplus continued to increase and the yen appreciated against the dollar.

The final policy option the government could use was monetary policy. In February 1993, the discount rate was reduced from 3.75 percent to 2.5 percent—equal to the postwar low—and there seemed little room for further reduction. The large-scale income tax cut proposed by the United States was opposed by MOF, which was concerned with the country's budget deficit and how to offset the loss of revenue that such a tax cut would entail. In mid-April, the Miyazawa administration announced a new ¥13.2 trillion economic stimulus package just before the prime minister flew to Washington to meet President Clinton. Despite the new package, which envisaged increased government spending amounting to 2.8 percent of GNP for one fiscal year, the U.S. government claimed that the Japanese measures were not enough. Japanese officials at MOF and the BOJ, however, tended to claim that the current account imbalances did not need to be adjusted and that Japan's current account surplus was useful because it enabled Japan to invest more overseas, thus helping the international economy (*Nihon Keizai Shimbun* 2 July 1993; Economic Planning Agency 1993, 290–294). This stance represented an apparent change in the Japanese government's attitude toward balance of payment adjustments.

Since further spending and tax cuts were difficult options for the government to take for balance of payments adjustment policy, monetary policy was the only remaining alternative. In September 1993, with the BOJ putting primary emphasis on the sluggish domestic economy, the discount rate was reduced to 1.75 percent (*Kinyūzaisei Jijō* 4 October 1993, 14–15). Reflecting MOF's strong opposition to an income tax cut, the economic policy package proposed by the Hosokawa administration that same month focused mainly on loosening government regulations and urging firms to pass the price benefits of the stronger yen on to consumers, and did not include a tax cut.

In April 1994, a temporary income tax cut was finally introduced. However, since this income tax cut was linked to a future increase in the sales tax, the United States expressed dissatisfaction with the plan. The fiscal 1994 budget included a mere 1 percent increase in overall spending from fiscal 1993's original level. Although two supplemental budgets for fiscal 1994 were approved in early 1995, the first supplement was designed mainly to help farmers affected by market liberalization under the Uruguay Round agreement and the second one was earmarked for helping the Kansai region, which had been devastated by the Great Hanshin-Awaji Earthquake in January 1995.

In light of a business survey that showed business confidence still deteriorating among Japanese firms in the spring of 1995, the BOJ, having resisted for a long time, finally reduced the discount rate from 1.75 percent to 1 percent in April, hoping to boost the economy. In May, the Murayama administration decided on the first supplemental budget for fiscal 1995 out of concern for the earthquake recovery efforts. Despite the Japanese government's application of expansionary monetary and fiscal policies in the spring, however, the yen appreciated rapidly, reaching a rate of nearly ¥80 = US$1. Faced with this rapid appreciation and a prolonged recession, the BOJ further reduced the discount rate to 0.5 percent in September.[8] Since the government realized that it was difficult to apply further reductions in the discount rate, the Murayama administration decided to introduce a second, large supplemental budget for fiscal 1995 in October. However, most of the money was earmarked for earthquake reconstruction and only limited amounts were tied directly to helping small and medium-sized businesses cope with the strong yen or to adjusting the external payment surplus. In other words, the decision to undertake fiscal expansionary policy was driven largely by domestic concerns about the earthquake and recession rather than by concerns about adjusting Japan's current account surplus in response to U.S. requests. The New Frontier Party, the largest opposition party, blamed the Murayama coalition government for taking no effective policy measures to halt the rising yen. The three coalition parties—the LDP, the Socialist Democratic Party, and Sakigake—finally agreed to set a target for reducing the current account surplus to within 1 percent of GDP over a period of three years, from 1996 to1998 (*Nihon Keizai Shimbun* 25 April 1995).

Compared to the cases in the 1970s and the 1980s, then, the Japanese government was clearly less eager in the early 1990s to use expansionary fiscal policy, although Japan was faced with a "hyper-valued yen" that was reaching historically high levels. The Japanese government hesitated to implement expansionary fiscal measures despite requests by the United States to do so for the purpose of adjusting the bilateral trade imbalance (Webb 1995). Once again, this change in policy choice can be attributed largely to changes in domestic preferences.

Changes in Domestic Preferences regarding Adjustments to the Current Account Surplus

Looking at the 1993–1995 period, during which the yen appreciated sharply, both export-oriented industries and export-oriented small and medium-sized businesses expressed their preferences against the strong yen as they had in the three previous cases from the 1970s and the 1980s. Despite the rapid yen appreciation, however, there was comparatively less resistance in Japanese society to the strong yen in the early 1990s. In particular, industry preferences regarding the adjustment of external payments had become increasingly diversified. In the cases of 1971–1973 and 1977–1978, immediately after the yen started to appreciate the leaders of the four peak business organizations[9] urged the government to implement expansionary fiscal policy in order to avoid a revaluation or appreciation of the yen. In the 1985–1987 case, however, business leaders were not as active initially in pressing the government to apply expansionary fiscal measures, partly due to their firm commitments to fiscal reform and partly due to the diffusion of industries' attitudes toward a strong yen (Kojō 1995).

In the early 1990s, this diffusion of attitudes was further intensified as the effect of the strong yen became clearly divided by industry—especially between export-oriented industries such as steel and automobiles, and nonmanufacturing industries such as banking and telecommunications (Nihon Keizai Shimbunsha 1993). The diversity in profits among industries had already become apparent in the case of 1985–1987 and was even more apparent in the early 1990s (Economic Planning Agency 1997). For business leaders, it became increasingly difficult to represent a diffuse set of industry preferences toward a strong yen. For example, there were diverse opinions expressed regarding the yen rate during the 1994 meetings of Keidanren, Japan's most influential peak business association, and as a result their policy emphasis was instead put on deregulation (*Gekkan Keidanren* September 1994).

Small and medium-sized businesses were also quieter than in the past on the issue of the strong yen. The National Federation of Small Business Associations (NFSBA: Zenkoku Chūshō Kigyō Dantai Chūōkai), was not as vocal in urging the government to take expansionary fiscal policy as it had been in the 1970s and the 1980s as a means to avoid further yen appreciation. In 1993, although the yen had started to appreciate, the primary concern of the NFSBA was the sluggish economy (*Chūshōkigyō to Kumiai* December 1993, 40–42). As the yen continued to appreciate into 1994, however, the organization did call for coordinated intervention in foreign exchange markets to curb the rising yen rather than expansionary macroeconomic policy (*Chūshōkigyō to Kumiai* August 1994, 26). It was not until the spring of 1995, however, that small and medium-sized businesses began to urgently demand that the government provide a large supplemental budget for small-scale businesses.

Industry, in general, had shifted its business strategies to adapt to fluctuations in the exchange rate after the Plaza Accord, and had thus become less sensitive to the strong yen. This change affected their preferences regarding current account adjustments. In the 1970s and 1980s, with a large payment surplus, exchange rate movements that were triggered by the government's policy of exchange-rate realignment as a means of addressing its external payment surplus provoked domestic resistance to the high level of the exchange rate. The preferences of most sectors in Japan tended to be against yen appreciation and, in turn, to favor expansionary fiscal policy. In the early 1990s, most industries were less sensitive to the strong yen and there was no unanimous domestic preference against further appreciation. Given this change in domestic preferences, the government was rarely faced with a trade-off between autonomy of macroeconomic policy and exchange-rate stability. Therefore, it can be assumed that the Japanese government had less incentive domestically to apply macroeconomic policy for the purpose of external balance of payments adjustment.

The shift in industry preferences regarding the exchange rate can be attributed to structural changes implemented in response to the post–Plaza Accord period of yen appreciation. First, many industries shifted their focus from overseas markets to the domestic market. The export dependence ratio of Japan actually declined after 1986. The strong yen also led to an expansion of the service sector, which is usually less sensitive to the yen's appreciation than the export-oriented manufacturing industries.

Second, Japanese industries rapidly increased overseas direct investment in the late 1980s in order to avoid potential losses and to take advantage of the currency's new strength. For example, automobile manufacturers shifted production facilities to the United States, and many producers of machinery and electronic equipment moved their operations to Asian countries. In 1989, there were more than 1,800 cases of overseas investment undertaken by Japanese manufacturers—more than 2.5 times the amount in 1985.

Third, Japanese industry underwent major restructuring and rationalization to cope with the strong yen. The average level of the yen-dollar exchange rate at which firms could make a profit rose by 20 percent between 1991 and 1995. This demonstrates the degree of rationalization that Japanese industries went through to cope with the strong yen.

Small and medium-sized businesses were hit most severely by the rise of the yen because they did not have as much room for rationalization or restructuring. One survey showed that among local small business manufacturing regions that exported more than 20 percent of their products, the export dependence ratio declined to 36 percent in 1992, down significantly from the 1985 level of 49 percent, and the number of firms declined by about 30 percent. This shows that small and medium-sized businesses made efforts to shift to domestic-oriented businesses under these severe circumstances (Small and Medium Enterprise Agency 1994, 37–73, 195–198). Of course, not only export-oriented but also import-competing small-scale businesses suffered from the impact of the strong yen, but they generally undertook rationalization to be less sensitive to exchange-rate fluctuations.

Japan experienced a major political change in 1993, when the LDP government, which had led the country since 1955, was replaced by a coalition government. Between 1993 and 1995, three coalition governments came to office—the Hosokawa government in 1993, the Hata government in April 1994, and the Murayama government in June 1994. Of course, this change of government affected the government's policy choices in terms of balance of payments adjustment. For example, the Hosokawa government tried to emphasize deregulation and the need to pass on the benefits of a strong yen to consumers. However, since the attitudes of the various political parties toward the problem of the current account surplus were almost identical, it appears that the changes in domestic preferences had more influence on the formulation of policy in this area than these political changes per se.

Conclusion

This study has examined the differences that occurred in Japan's policymaking regarding the adjustment of its balance of payments between the 1970s–1980s and the 1990s. In conclusion, we can emphasize three points. First, domestic preferences clearly influenced Japan's policy choices regarding the method of making balance of payments adjustments in the postwar period. From the 1970s to the 1990s, when the current account surplus surged, yen appreciation occurred in the foreign exchange market at the same time. Under these circumstances, there was a predominant domestic preference for the adoption of alternative policy choices over a further appreciation of the yen. Export-oriented industries and small and medium-sized businesses were especially sensitive to the exchange-rate level and pressed the government to stop the rise of the yen. Political parties, in turn, were sensitive to such domestic preferences because all political parties relied on small and medium-sized businesses for important electoral support. Therefore, there was a domestic bias in Japan in favor of expansionary fiscal policy. This argument challenges the conventional understanding of exchange-rate policy, which holds that there are negligible domestic preferences regarding the exchange rate and minimal lobbying activities to influence exchange-rate policy.[10]

Second, economic internationalization affected the preferences of industries in Japan. Since the 1980s, financial liberalization and the easing of capital controls have led to the internationalization of capital movements. In a floating exchange rate system with massive capital mobility, exchange-rate fluctuations became a common occurrence. With a large current account surplus, the exchange rate for the yen tended to appreciate. In the 1970s and 1980s, Japanese industries—especially export-oriented industries—believed that a strong yen would reduce their competitiveness overseas. Therefore, they preferred that the government apply expansionary fiscal policy for external balance of payments adjustment. However, from the late 1980s, Japanese industries realized that the appreciation of the yen was a result of economic internationalization and began to implement strategies to cope with it. A review of the case of the early 1990s implies that this change in domestic preferences did indeed affect the policy choice of the government regarding external balance of payments adjustment.

Finally, the review of the early 1990s case shows that economic internationalization undermined the effectiveness of policy instruments for external balance of payment adjustment. In the 1970s and 1980s, expansionary fiscal policy was regarded not only by the U.S. government but also by the Japanese government as an effective instrument for reducing the current account surplus by expanding the domestic economy. Therefore, fiscal expansion was taken as an alternative policy choice to yen appreciation. However, since fiscal expansion was not as effective as expected, the argument was raised that—in keeping with the Mundell-Fleming model—with massive capital mobility, expansionary fiscal policy would lead to yen appreciation in the short run by putting upward pressure on the interest rates. The effectiveness of expansionary fiscal policy in stemming yen appreciation was therefore called into doubt. This may be one reason why industry was less eager to press hard for expansionary fiscal policy in the case of the 1990s.

In the late 1990s, Japan's current account surplus rose again and the United States current account deficit grew as well. The trade imbalance between Japan and the United States was large and widening. The U.S. government warned the Japanese government of the undesirability of Japan's current account surplus. Similarly, the IMF also expressed its concern over the danger of the growing current account imbalances between the United States and other industrial states (Warner 1999). However, since the Japanese economy remained stagnant, still suffering from the aftereffects of the collapse of the bubble economy and the Asian financial crisis, the Japanese government was more concerned with boosting the stagnant domestic economy than adjusting the current account surplus per se. Since the yen's value against the dollar had been gradually declining from the mid-1990s on, and since the domestic economy had become less sensitive to changes in the exchange rate as described above, there was less domestic pressure for the government to apply macroeconomic policy to avoid a stronger yen. In addition, the Japanese government was constrained in its use of expansionary fiscal policy by its huge budget deficit.

The government's policy choices in the late 1990s, however, were dominated by its concern over how to boost the domestic economy. As a result, in response to U.S. demands to reduce the current account surplus, the Japanese government put its emphasis on policies for deregulating markets. Since Japan's economy remains sluggish, the U.S. government has refrained from exerting too much pressure on the Japanese government. However, when the Japanese economy recovers, it is likely that the U.S. government will once again put Japan's current account surplus on the political agenda of the bilateral relationship, since the U.S. current account deficit and trade deficit with Japan will undoubtedly increase. At that time, if there is still limited domestic support for applying macroeconomic policy in Japan, it is unlikely that the U.S. government will experience the same success it did in the 1970s and 1980s in pressing the Japanese government to adopt this policy option to correct its external surpluses.

Notes

1. Regarding the existence of various models for international macroeconomic policy coordination, see Frankel (1988).

2. Cooper defines three categories of policy instruments under fixed exchange rates: external, internal, and financing measures (1968, 13–23). Webb shows three categories: external policy, symptom management policy, and internal policy (1991, 314).

3. In a floating exchange rate system, with massive and rapid capital mobility, it has become much more difficult to alter exchange rates through a single country's intervention.

4. It should be noted that this categorization is based on conventional theory on policy instruments for current account adjustment, but there is no theoretical consensus on the effectiveness of each policy instrument.

5. In 1971, exports by small and medium-sized businesses comprised 40.2 percent of Japan's total exports and 43.5 percent of exports to the United States (Ohtsu 1971).

6. Rosenbluth (1993) focuses on the LDP's compensation policy for small-scale business in the period of the strong yen. However, it was not only the LDP but also other political parties that emphasized compensation for small-scale businesses.

7. The choice to use expansionary macroeconomic policy was also apparent in the making of the 1971, 1972, and 1973 budgets (Andō 1987; Yanagisawa 1985).

8. The BOJ was reluctant to reduce the rate. The bank's position, as expressed by the bank's president at that time, Matsushita Yasuo, was that it was not appropriate to apply monetary policy to stabilize exchange rates (*Nihon Keizai Shimbun* 8 March 1995).

9. The four peak business organizations are Keizai Dantai Rengōkai (Keidanren: Japan Federation of Economic Organizations), Keizai Dōyūkai (Japan Association of Corporate Executives), Nihon Keizaidantai Rengōkai (Nikkeiren: Japan Federation of Employers' Associations), and Nihon Shōkō Kaigisho (Nisshō: Japan Chamber of Commerce and Industry).

10. For an exceptional study, see Henning (1994). This study emphasizes societal preferences regarding exchange-rate policy in Japan, Germany, and the United States.

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