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4 The Transformation of Japan's Fiscal Orientation in the 1990s:

The Impact of External Pressure, Volatile Party Politics, and Recession

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UNTIL RECENTLY, JAPAN WAS A UNIQUE CASE of successful democratic capitalism outside the Western world. In the 1950s and 1960s, Japan achieved outstanding growth and industrialization in a benign global economic climate. In the 1970s, after the oil shock of 1973, the rapid-growth period abruptly ended, but Japan enjoyed good economic performance relative to other industrial democracies, with lower unemployment and a stable but higher growth rate than other industrial countries. In the 1980s, as Japan continued to enjoy good economic performance, its industrial products penetrated the markets of the United States and other industrial countries. This was regarded as a threat by other countries and intensified trade friction with Japan. The successful penetration of Japanese products was allegedly the result of "strategic trade" (pushing down export prices while keeping the domestic market closed) rather than international competitiveness. The yen appreciated massively after the Plaza Accord of 1985, but Japan's trade surplus did not decrease.

The "bubble economy" of the late 1980s seemed to confirm the strength of the Japanese economy and the advantages of Japanese-style capitalism. At the same time, the strategic and predatory nature of Japan's exports and the peculiarities of its industrial organization and business practices attracted criticism. Before the endless debate was resolved the bubble burst, and the Japanese economic downturn became apparent in 1992. Since then, the erstwhile high praise for Japanese capitalism has been reversed; yesterday's strength has become today's weakness. Japan's industrial structure and business practices, such as the *keiretsu* business groups, the seniority-based wage system, and lifetime employment, were once praised for cultivating loyalty among workers and continuity in business strategy. Now they are regarded as signs of a lack of flexibility and as obstacles to new solutions. The main-bank system and the allocation of industrial funds were once considered the reason for the flexible shift from one industrial sector to another. But as the number of failing financial institutions has increased, the government's supervision of the financial market and the tight organization of the industrial sector have become targets of censure.

Despite the ups and downs of the Japanese economy in the global context, Japan's economic policy, especially the style of economic cooperation with other industrial democracies, appears unchanged. Japan has been named a "reactive state" by Calder (1988), meaning that its foreign policy, including its economic policy, is determined more by response to other countries' demands and requests than the voluntary and independent action of the Japanese government. The United States in particular, as an economic hegemon, has demanded that Japan share the cost of maintaining the international economic order instead of just enjoying its fruits. Japan, the most privileged beneficiary of the order, has been accused of free riding on the provision of a public good (the international economic order) at the expense of the United States. Since consumption of a public good is indivisible, nonexcludable, and nonrival, the hegemon that can afford to provide it cannot directly demand payment from consumers.[1] Thus, the demands of the United States as a hegemonic power vis-à-vis Japan were focused on the coordination of economic policy as well as policy change in trade.

More specifically, the United States has demanded fiscal activism and expansion of domestic consumption. Japan's good economic performance and trade surplus in the 1970s and 1980s had led to these demands. Expanding public expenditures in Japan was believed to be desirable for the stagnant global economy, and increasing domestic consumption would serve to reduce the U.S. trade deficit. In the 1990s, with the declining fortunes of the Japanese economy, the necessity of economic recovery for Japan itself became the reason for such demands. This was urgently pursued by Japan and desired by other countries, which were afraid of a spillover of Japan's recession to the rest of Asia and elsewhere. In short, Japanese economic policy not only in trade and currency but also in public financial management was exposed to other countries' demands and, more importantly, looked as though it were reacting to such demands.

Against the above conventional view, on the basis of a brief examination of changes in the 1990s, I argue that the Japanese economic policy response has not been reactive. Although Japanese economic policy has seemed to follow external pressure (*gaiatsu*), the meaning of the interaction between external pressure and Japanese government action in the 1990s was distinct from that in the 1970s and 1980s. Two important factors that are likely to have influenced this change are the deep and long recession that replaced good economic performance and the increasing volatility of party politics that replaced the one-party dominance of the Liberal Democratic Party (LDP) from 1955 to 1993. After briefly describing the characteristics of the Japanese response to external pressure in the 1970s and 1980s, I will examine the interaction of Japanese fiscal policy and external pressure in the 1990s.

Japan in the 1970s and 1980s

The oil shock in the autumn of 1973 was an event that symbolized the termination of post–World War II fast economic growth and also determined the style of interaction between Japanese fiscal management and external pressure. Although it is reasonable for foreign economic policy, such as trade and currency exchange, to be influenced by demands and requests from other countries, it does not automatically follow that external pressure influences fiscal orientation, which is a domestic economic policy. International coordination of economic policy is no longer a new subject of study in economics, and thus it is possible to conceive of a situation in which changing the fiscal orientation because of external economic considerations would bring optimal results for all. The external pressure on Japan does not appear to have been part of a "coordination," however, because the relationship has always been unilateral, that is, other countries have presented demands to Japan much more often than Japan has to other countries. Industrial democracies' policy response to the oil shock followed this basic pattern of interaction between Japanese fiscal policy and external pressure: Other countries demanded fiscal activism and the expansion of domestic consumption, and the Japanese government responded to the demand, though with reluctance and a time lag.

After the oil shock, the active fiscal orientation of the Tanaka Kakuei cabinet was expected to end with the appointment in November 1973 of Fukuda Takeo, who was a fiscal conservative, as minister of finance. Facing a soaring interest rate, which climbed to 24 percent in 1974, Fukuda tightened the budget, especially public works expenditures, though he left intact a ¥2 trillion income tax cut and an increase in social security expenditures. Despite fiscal consolidation as finance minister, Fukuda was forced to abandon his ideal of fiscal conservatism and shift to fiscal activism after he became prime minister in 1976. At that time, a relatively high growth rate and low unemployment rate were becoming apparent in Japan and West Germany. At the Group of Seven (G7) summit in Bonn in 1978, Fukuda accepted the "locomotive theory" (*kikansha ron*), according to which Japan and West Germany were capable of pulling along the faltering world economy, and he promised a 7 percent gross national product (GNP) growth rate. The United States, which was suffering from inflation, a trade deficit, and a weak dollar, had demanded this, and other countries had also become more critical of the inaction of Japan and West Germany. But Fukuda's decision was attributed to a sense of duty that countries with stronger economic outlooks, such as Japan and West Germany, had an obligation to pull along the global economy. Fukuda left an interesting commentary on his own decision. Domestic pressure from major business associations for a fiscal-stimulus package was also strong, but Fukuda asserted that he would not have launched an active fiscal program without taking into consideration the global economic situation (Andō 1987, vol. 2, 79–81). This pushed public works expenditures above the level of the 34.5 percent increase provided in the fiscal 1978 (April 1978–March 1979) original budget by adding another fiscal-stimulus package.

It is noteworthy that Japan was not necessarily in a position to indulge easily in fiscal expansion. After the first issuance of deficit bonds in the fiscal 1975 supplementary budget, the ratio of dependence on deficit bonds in the fiscal 1976 budget was 29.9 percent, and the ratio in the fiscal 1978 budget was 32.0 percent. The recession following the second oil shock in 1979 caused a large revenue shortfall, and deficit financing was inevitable. The bond dependence ratio hit a peak of 39.6 percent in fiscal 1979 and then started to decline, but until the late 1980s the dependence ratio was higher than the average in industrial democracies. For example, in fiscal 1984 it was as high as 25.0 percent, even higher than the worst case in the United States. Fukuda had been reluctant to respond to major business associations' demand for a fiscal stimulus but decided to shift to fiscal activism out of consideration for international economic management.

To sum up, Japan's implementation of a fiscal-stimulus package in the mid-1970s followed external pressure, but there remains the possibility that the decision was made voluntarily, according to the above evidence about Fukuda. As a fiscal conservative, he very likely expected that fiscal expansion would lead to chronic deficit financing. Despite this concern, Japan's good economic performance led Fukuda to accept the demands from abroad and launch an active fiscal program.

Japan's economic response to the oil shock illustrates the style of interaction between external pressure and fiscal management in the 1970s and the 1980s. Good economic performance in Japan intensified pressure from abroad. In the eyes of other countries, Japan could afford the fiscal expansion that was desirable for the international economy, and the United States felt that this was a cost that Japan had to pay while enjoying the stability of the international economic order. Its good economic performance despite the difficulties of other countries gave Japan a sense of guilt and caused it to implement the policies they demanded. If its performance had been even better, the external pressure would have been intense, and Japanese sensitivity to global economic conditions was high. In this regard, the Japanese response was not entirely forced by other countries and thus was not necessarily reactive.

The implementation of an economic stimulus desired by other countries was not necessarily a reasonable choice for Japan. The nation was suffering from a recession, but to a lesser extent than other countries, and there was a potential threat of chronic budget deficits. Japan was reacting to the fact that it was performing better economically than other countries rather than to their demands. Both the intensity of other countries' demands and the Japanese sensitivity to global economic conditions were functions of Japan's economic performance, and they worked in the same direction.

The decline in Japan's economic performance, which was worse than other countries' in the 1990s, provides a good test case of my argument. The next section will follow the changes in Japanese fiscal policy and external pressure since 1992, when the serious economic downturn became public knowledge.

Declining Economic Prominence and Political Instability in the 1990s

Economic Stimulation, 1992–1996: External Pressure and Japan's Response

At the beginning of 1992, when President George Bush visited Japan, the United States demanded an expansion of Japanese domestic demand and an economic-stimulus package. At that time, Japan was still regarded as the only country that could afford to implement an expansionary fiscal program for the purpose of global economic recovery. Germany was suffering from high inflation, and the United States had both budget and trade deficits. Bush especially desired an economic recovery led by Japan to strengthen his standing in an election year. Prime Minister Miyazawa Kiichi had been finance minister in the mid-1980s, when Japan had responded to a U.S. request to stimulate domestic demand and had entered the phase of the bubble economy. Thus, Japanese policymakers were afraid meeting the 1992 demand would lead to a return of the bubble economy and so did not consider seriously the need to stimulate the economy.

Meanwhile, it became apparent that the financial authorities had underestimated the adverse effects of the bubble's collapse on economic growth. Subsequently, the United States became concerned about the increasing Japanese trade surplus and intensified its demand for fiscal expansion to decrease the surplus. In April 1992, shortly after the Japanese government announced a fiscal-stimulus package, a top official of the U.S. Department of the Treasury said that further fiscal expansion was necessary to achieve the goal of 3.5 percent growth and decrease the trade surplus.[2] Japan's slowed growth and mounting trade surplus were the focus of the G7 meeting at the end of April, since Germany's high interest rates to cope with inflation were accepted. Despite the fiscal-stimulus package and the lowering of interest rates, pressure to expand domestic demand was increasing, but the Ministry of Finance (MOF) indicated that it would maintain the policy of eliminating the budget deficit.

In May, the trade surplus was at a peak. At the ministerial meeting of the Organization for Economic Cooperation and Development (OECD) countries that month and at the G7 summit in July, Japan was requested to make additional public expenditures to stimulate the economy. Japan's economic performance was still regarded as somewhat better than that of other countries. In August, the government introduced a fiscal-stimulus package financed by Fiscal Investment and Loan Program (FILP) lending and reserve funds as well as construction bonds. Total spending amounted to more than ¥2 trillion, although most funds went to land purchases. Toward the end of the year, the pressure from abroad increased, and the Japanese government attempted to intervene in the stock market with trust funds to stimulate the economy.

Nineteen ninety-three was a year of changes on both sides of the Pacific. In the United States, Bill Clinton was inaugurated as president and brought with him a team of economic experts, such as Lawrence Summers (deputy secretary of the treasury), Laura Tyson (chair of the Council of Economic Advisers), and Mickey Kantor (U.S. trade representative), who subsequently pressed Japan hard to eliminate the trade imbalance. On the Japanese side, the LDP lost power that summer and a non-LDP government was formed for the first time in thirty-eight years.

Simultaneously with this big political change, the economic situation in both countries was changing. At a meeting of the G7 ministers of finance and central bank heads in March, all other countries demanded that Japan stimulate domestic demand; the U.S. economy was showing signs of recovery, but not enough to revive the global economy. At the time of the G7 summit meeting in July, which Prime Minister Miyazawa chaired, Japan was enjoying a relatively good economic performance and presumably could afford to take measures to increase public spending (that is, without concern about high inflation and trade deficits) for the sake of the recovery of the global economy.

After the passage of the fiscal 1993 budget, Miyazawa introduced a package of "new comprehensive economic measures" (*shin sōgō keizai taisaku*). Aside from the supplementary budget (about ¥2.2 trillion) and tax cuts (¥2.25 trillion), most of the ¥13.2 trillion package was poured into public works. This package was regarded as a sign of the government's strong intention to stimulate the economy, but the spending included ¥11 trillion from the FILP that had been decided on earlier.

After Hosokawa Morihiro formed a non-LDP coalition cabinet in August, following the LDP's rout in the July general election, U.S. concern over the prolonged and deepening recession in Japan heightened. The demand for a more active fiscal orientation continued and became even stronger, but this was because the United States was concerned about the adverse effects of the recession in Japan and no longer expected that Japan could take a more active role bolstering global economic recovery. Economic stimulation was necessary for Japan, but its policy response appeared to be ineffective because of increasing constraints over policy options, not insensitivity to the worsening economic situation and increasing external pressure.

For example, immediately before the new government's announcement of emergency economic measures (*kinkyū keizai taisaku*) on September 16, Treasury Deputy Secretary Summers visited Japan to examine the expected effect of the measures and judge whether to demand additional measures. The measures included ¥6 trillion of public spending, but again most came from the FILP instead of the general account.[3] Thus, at the G7 ministerial meeting and at a meeting with the United States, a tax cut became a public promise to the international community. The concern of Japanese policymakers here was how to maintain the principle of zero issuance of deficit bonds with no financial source for a major tax cut other than deficit bonds. Generally speaking, the issuance of bonds for a tax cut is not classified as the same as the issuance of construction bonds for investment in economic and social infrastructure. The government announced its intention to issue temporary bonds (*tsunagi kokusai*). This name implies that they are different from construction bonds but also different from deficit bonds because they should not accumulate into chronic debt. A ¥5.85 trillion income tax cut was included in the comprehensive economic measures announced on February 8, 1994, and subsequently passed by the National Diet. These measures constituted the largest (¥15.25 trillion) stimulus package so far, providing ¥7.2 trillion for public works, financed by the FILP, as well as ¥2.19 trillion for small and medium-sized businesses, financed by bonds.

The government's initiative to stimulate the economy was neither clear nor assertive, however, and this was attributed to lack of stability in the coalition government. First, on February 3, 1994, Prime Minister Hosokawa announced that in fiscal 1996 he would raise the consumption tax from 3 percent to 7 percent and rename it the "national welfare tax" (*kokumin fukushi zei*). This proposal was supported by Ozawa Ichirō, then head of the Japan Renewal Party, and Saitō Jirō, MOF vice-minister. But it had not been known to, let alone agreed to by, all members of the ruling coalition, especially the Social Democratic Party (SDP) and New Party Sakigake (*sakigake* means pioneer), nor was it based on a firm consensus within MOF (Katō 1997).[4] Although the proposal was withdrawn immediately because of strong public opposition as well as criticism within the coalition, this incident showed that MOF's concern over the growing budget deficit was increasing and that there was disagreement within the coalition over fiscal policy. The passage of the fiscal 1994 budget was delayed until June by the disintegration of the coalition. It passed the House of Representatives on June 8 and the House of Councillors on June 23 as the LDP challenged the disintegrating coalition, although it did not necessarily oppose the content of the budget. Consequently, although fiscal policy was an issue that divided the coalition, partisan conflict also caused the delay and inconsistency of the fiscal program.

The coalition government was headed by Hata Tsutomu after Hosokawa's resignation in April. It passed the budget but was short lived because it was a minority government as a result of the defection of the SDP and Sakigake. In late June, the LDP returned to power in coalition with the SDP and Sakigake and supported SDP Chairman Murayama Tomiichi as the first socialist prime minister in more than forty years. The need to recover from the recession was the immediate concern of the new coalition. Its approach was tax reform, in which an income tax cut would precede a tax increase to be achieved by raising the consumption tax from 3 percent to 5 percent in fiscal 1997. Because of the expansionary fiscal orientation preferred by the SDP and Sakigake, the ¥5.5 trillion income and residential tax cut included a ¥3.5 trillion permanent cut and the consumption tax would rise only to 5 percent rather than 7 percent as previously planned. In addition, a New Gold Plan for the elderly, a welfare compensation package to cope with the regressive consumption tax increase, was to be introduced in fiscal 1995, and the revenue from 1 percent of the consumption tax increase was to be transferred to regional and local governments.

During the tenure of the non-LDP coalition, the LDP had become increasingly suspicious of the bureaucracy, which had cooperated with the coalition parties. MOF had apparently made concessions to the unstable coalition (Katō 1997). Despite substantial political intervention, specifically the SDP's desire to precede an economic stimulus with a tax increase, however, the fiscal authorities' optimism over the prospects for economic recovery were reflected in a tax-reform package that combined an income-tax cut with a consumption-tax increase. The fiscal authorities believed that the economy could recover well before April 1997, when the consumption tax would be raised. Thus, the government could avoid the loss of tax revenue and the unnecessary accumulation of budget deficits and pursue the two goals of economic stimulus and fiscal reconstruction. In line with this tax reform, in December 1994 the government decided on a fiscal 1995 initial budget that was 3 percent smaller than the fiscal 1994 budget and included ¥1 trillion less in total bond issues (¥200 billion in temporary-bond issues). This optimistic outlook for economic recovery was similar to the optimism over the prospects for resolution of the financial-market crisis that had led to a delay in pouring public money into the market. Loosening money was necessary for economic recovery, but in retrospect we can see that the unhealthy management conditions of financial institutions prevented firms from gaining investment money to build up their businesses.

The year 1995 started with the Great Hanshin-Awaji Earthquake on January 17. This increased the expectation that the economy would improve because of the necessity for reconstruction and rebuilding in the Kobe area. The government passed a ¥1.02 trillion supplementary budget in February aimed at increasing both general-account and FILP spending, but the growth rate was not as high as expected. Pressure from abroad to expand domestic consumption increased, due mostly to the rapid rise of the yen from approximately ¥100 to the U.S. dollar at the beginning of February to close to ¥80 to the dollar near the end of April. This nearly 20 percent increase in the value of the yen caused the government to issue a set of countermeasures (*kinkyū endaka keizai taisaku*) worth ¥4.62 trillion (¥2.73 trillion from the general account) in addition to an interest rate cut in April. The continuing strong yen led the government to implement another fiscal-stimulus plan in September, this one worth ¥14.2 trillion, including ¥5.3 trillion from the general account and ¥4.9 trillion in bonds.

The government's successive actions to stimulate the economy in fiscal 1995 had mixed results. That fiscal year the government issued a total of ¥21.25 trillion in bonds—far more than the initially planned ¥12.6 trillion. This was the highest level of spending for economic stimulus of the past decade, but at the same time the figures were often exaggerated. For example, actual general-account expenditure increased by only ¥4.95 trillion in fiscal 1995, and actual FILP spending increased by only ¥5 trillion. In other words, either the spending did not take place in that year or spending already budgeted was included in the stimulus packages.

The government's equivocal approach in fiscal 1994 and 1995 paralleled weakening pressure from other countries, especially the United States, to expand domestic consumption and stimulate the economy. The strong yen and the prolonged recession were reasons for other countries' demands, but at the same time troubles in Japan's financial market caused by failing financial institutions softened the pressure. The bankruptcies of Tokyo Kyōwa and Anzen credit cooperatives in March, Cosmo credit cooperative in July, and Kizu credit cooperative in August were the first symptoms. In August, Hyōgo Bank became the first bank during the post–World War II period that could not be saved by a merger with another bank, and went out of business. Moreover, in September it was revealed that Daiwa Bank's New York branch had hidden from the U.S. authorities losses amounting to US$1.1 billion. This was attributed to the wrongdoing of a young trader, but MOF, which had been informed of the situation in August, did not report it to the U.S. Federal Reserve Board until the scandal was revealed. While this series of troubles diminished confidence in Japanese financial institutions and the government's regulatory capability, other countries, especially the United States, shied away from being hard on Japan simply because they were afraid that the recession and financial-market crisis would spill over from Japan to the rest of the world.

The Shift to Fiscal Structural Reform, 1996–1997

In fiscal 1996, the climate in fiscal policy changed from an expansionary orientation to one of fiscal consolidation. The most important factor was a sign of economic recovery—annual growth in gross domestic product (GDP) rose to 2.4 percent and the economy was stable, with no signs of either inflation or deflation. In retrospect, this benign economic climate should not have been exaggerated, since the expected rise of the consumption tax from 3 percent to 5 percent in April 1997 increased the consumption of consumer durables. But at the same time, as MOF announced in July 1996, tax revenue in fiscal 1995 had increased for the first time in five years. Thus, there was another reason to believe that the economy was recovering. In this situation, the growing budget deficit turned the Hashimoto Ryūtarō cabinet, formed in January 1996, toward fiscal consolidation.

The necessity to mop up after failed *jūsen* (*jūtaku kinyū senmon gaisha*, companies specializing in housing loans) was put at the top of the economic policy agenda, along with restoring order in the financial market in general. Despite public criticism, in April the government decided to pour ¥685 billion into the market and passed the fiscal 1996 budget, which included this investment of public funds. Immediately after the passage in June of bills to implement the liquidation of the *jūsen* with the help of public funds, Prime Minister Hashimoto decided to relax the ceiling on ministry budget requests. The ceiling was not strictly imposed on the ministry budget requests made public in September, and thus general-account spending was expected to increase by 2.9 percent. But the fiscal authorities expected that increased tax revenue from a higher consumption tax and economic recovery would lower the budget's bond dependence rate from 28 percent to 21.6 percent.

Late that year, the government began to tackle fiscal consolidation from a long-term perspective. First, in December the Fiscal System Council issued a report articulating the goals of lowering the budget deficit ratio to GDP of local governments and the national government to 3 percent and eliminating the issuance of deficit bonds by 2005. The report was taken to the newly formed Conference on Fiscal Structural Reform headed by Prime Minister Hashimoto, whose members included former prime ministers, finance ministers, and executives of the LDP, the SDP, and Sakigake.

The conference began deliberations in January 1997, Hashimoto presented the principles for reform in March, and the conference issued its final report in June. The report was adopted immediately by the cabinet and legislation reflecting its recommendations was passed in late November. The legislation proclaimed the aims of reducing the budget deficit ratio to GDP of both local governments and the national government to 3 percent and eliminating the issuance of deficit bonds by 2003, and specified the details of spending cuts from fiscal 1998 to 2000.

Meanwhile, pressure from other countries was at least not thwarting the government's orientation toward fiscal consolidation, mainly because other countries' attention was focused on their own budget deficits in 1996. At the G7 meetings of finance ministers and central-bank heads in January, April, and September 1996, Finance Minister Kubo Wataru emphasized that Japan's budget deficit was the highest among the G7 countries and requested understanding of the need for fiscal consolidation.[5] At the OECD ministerial meeting in May, Japan pledged a 3 percent budget deficit ratio, which incidentally was the target for countries participating in European monetary union (EMU). Although the United States demanded further economic recovery, a distinction was made between the expansion of public spending and of domestic consumption, the United States emphasizing the latter at the expense of the former. Both the United States and European countries were forced to put the highest priority on the reduction of budget deficits. The U.S. government was faced with demands from Congress, while the European governments had to meet the requirements for participation in the EMU, and thus could not press Japan, which was still on the way to recovery.

This trend continued until the middle of 1997. Later that year, stagnant domestic consumption made other countries more doubtful of Japan's economic recovery. For example, at the G7 meeting in September the United States focused on Japan as well as the resolution of the Asian currency crisis. U.S. suspicions about the fragile nature of Japan's economic recovery appeared to be confirmed by the bankruptcies later that year of two financial institutions once believed invincible: Yamaichi Securities, one of the "big four" Japanese securities firms, and Hokkaido Takushoku Bank, a major city bank.

Deepening Recession, Faltering Financial System since the End of 1997

The failure of two major financial institutions interrupted the government's efforts toward fiscal structural reform. Only the issuance of deficit bonds, which ran counter to the aim of the fiscal-reform legislation, could finance the massive amount of public funds that were being provided to deteriorating financial firms through the Deposit Insurance Corporation of Japan. The Hashimoto cabinet finally decided to inject money into the financial market in December at the expense of fiscal reform. Japan faced a stalling bank system, the spread of the currency crisis, and the stock market collapse across East Asia; the international community believed that recovery of the Japanese economy was essential to help ailing Asian economies. It was decided to use at least ¥10 trillion of public funds to rescue shaky banks and deal with the financial-market crisis. In addition, without seeing any sign of economic recovery, the Hashimoto cabinet decided on a special cut of ¥2 trillion in income and residential tax in the fiscal 1997 supplementary budget. The tax cut was again financed by the issuance of deficit bonds. Consequently, both the financial crisis and the prolonged recession forced the Hashimoto cabinet to abandon the major economic reform aim of fiscal reconstruction. But the government's fiscal orientation did not shift immediately. The initial budget of fiscal 1998, drawn up at the end of 1997, abided by the requirements in the fiscal-reform legislation and thus decreased general expenditures for the first time in eleven years, and the general account increased by only 0.4 percent. The budget was ineffective for fiscal consolidation because the issuance of deficit bonds increased from ¥6.25 trillion, the upper limit set by the reform plan, to ¥7.13 trillion. The dependence ratio on deficit bonds, 20 percent, was the highest among major industrial democracies.

The first two years of the Hashimoto cabinet thus ended with declining popular support due to a stagnant economy and financial crisis. Opinion polls in the major newspapers around the turn of the year to 1998 reported the lowest support rates for the Hashimoto cabinet so far. An *Asahi Shimbun* opinion poll in December 1997 recorded a 36 percent support rate, comparable to that in September 1997, when Satō Kōkō, who had been convicted in 1986 for his role in the Lockheed bribery scandal of the mid-1970s, had to resign his cabinet post. The *Nihon Keizai Shimbun* reported a 30 percent support rate in January 1998 due to dissatisfaction with the weak economic-stimulus measures.[6]

The disclosure in January 1998 of a collusive relationship between MOF officials and financial institutions was a severe blow for the Hashimoto cabinet as well as MOF. Two MOF bank inspectors were arrested, whereupon first Minister of Finance Mitsuzuka Hiroshi and then the vice-minister, MOF's highest ranking bureaucrat, resigned. In March, two more MOF officials were arrested, including one who was on the fast track to high office. They had provided major securities companies and banks with inside policy-making information and given new licenses and permissions in exchange for money and lavish entertainment. This led to the humiliation of many high-ranking MOF officials, including resignations and pay cuts in April. At the same time as the MOF scandal, a bribery and corruption case involving the Bank of Japan (BOJ) was disclosed, and the BOJ governor resigned.

The loss of confidence in public authorities because of these scandals was problematic, in the light of the worsening Japanese economy. The previous year, there had been a minus growth rate (−0.7 percent) in GDP for the first time in twenty-three years and for the second time since 1951, when the government began to issue statistics. In 1998, economic growth continued to stagnate, and the rising unemployment rate, which was above 4 percent, also became a potential threat to economic recovery.

To cope with this situation, in April the government abandoned the priority of fiscal consolidation. Revised structural fiscal reform legislation was enacted at the end of May. The year to eliminate deficit bonds was postponed from 2003 to 2005, and the cap on social security expenditures was lifted. Based on this revision, on April 24 the government announced a package of comprehensive economic measures that included a ¥4 trillion special one-off income tax reduction beginning in fiscal 1998 and ¥7.7 trillion for public works. Altogether, spending (including tax expenditures) amounted to ¥16.65 trillion, exceeding the past record of ¥15.25 trillion in February 1994 and including a record ¥12.3 trillion in fiscal-stimulus expenditures. The Economic Planning Agency estimated that these measures would enable Japan to meet the target of 1.9 percent growth in fiscal 1998.

The prospects for economic recovery and fiscal consolidation were dim, however. At the beginning of June, when the −0.7 percent growth rate was disclosed, a revenue shortfall of more than ¥1 trillion in fiscal 1997 became apparent (the first such shortfall in four years). Economic recovery, especially an income tax cut, became the most important issue in the July House of Councillors (Upper House) election. The LDP, which had already terminated its coalition with the SDP and Sakigake, failed to win as many seats as it had in the previous Upper House election, held in 1995. When its 44 seats were combined with the 58 seats not up for election, the total of 102 seats was far short of a majority, 126 of the 252 Upper House seats. This dismal result was considered a sign of public dissatisfaction with the LDP government's efforts to stimulate the economy. Prime Minister (and LDP President) Hashimoto resigned, and in the ensuing election for a new LDP president economic policy was also an issue. The newly elected president, Obuchi Keizō, became prime minister. He appointed former Prime Minister Miyazawa finance minister in the expectation that his expertise in economic policy would help the Japanese economy recover from the prolonged recession. Because a former prime minister rarely becomes a minister in Japan, this appointment was considered an indication of the LDP's sense of crisis over economic management.

Miyazawa decided on another income tax cut in fiscal 1999 to revitalize the economy, but because of the fiscal 1997 revenue shortfall no financial source could be found except deficit bonds. Although the structural fiscal reform legislation had been revised, the issuance of deficit bonds was still against the government's principles. The government also decided to cut corporate tax. Tax reduction amounted to more than ¥7 trillion overall. But the government avoided structural change aimed at a permanent reduction of the tax burden, implementing a fixed-rate ¥4 trillion income tax cut. The highest tax rate at both the national and the local levels was lowered from 65 percent to 50 percent, but in the lower tax brackets a special one-off flat-rate tax reduction was implemented, that is, 20 percent in income tax at the national level (with an upper limit of ¥150,000) and 15 percent in residential tax at the local level (with an upper limit of ¥40,000). Since fiscal 1994, only the ¥3.5 trillion cut in fiscal 1995 had been a permanent reduction related to structural change. Other tax cuts—¥5.5 trillion in fiscal 1994, ¥2 trillion in fiscal 1995, ¥2 trillion in fiscal 1996, ¥4 trillion in fiscal 1998—were special one-off reductions, like the one in fiscal 1999.

In drafting the budget for fiscal 1999 in August 1998, Miyazawa combined the supplementary budget of fiscal 1998 with the initial budget of fiscal 1999 and incorporated more than ¥12 trillion for public works projects over fifteen months (January 1999 through March 2000) to stimulate the economy. General expenditure for fiscal 1999 increased by 11 percent, indicating an apparently active fiscal program.

Resolving the financial-market crisis was an even more urgent concern than stimulating the economy. In October 1998, the Diet passed bills to invest public funds in the financial industry to protect depositors from bankruptcy and to rectify the adverse management situations of financial institutions. Because of the LDP's weak hold on power, however, both houses amended the bills. A major LDP concession was to abandon the investment of public funds in the foundering Long-Term Credit Bank of Japan, one of the three major banks concerned with industrial lending, a bank that the LDP was keen to shore up. Another LDP concession to the opposition, specifically the New Kōmeitō, was agreement to provide merchandise vouchers worth ¥20,000 to thirty-five million people aged fifteen or under and sixty-five or over.

As the Japanese economy floundered, external pressure to stimulate it increased, especially from the United States. From the beginning of 1998, it was reported that the government had promised to implement a fiscal 1998 supplementary budget to stimulate the economy, although senior officials denied this.[7] In the G7 meetings in London in February and in Washington in April, other countries, especially the United States, strongly demanded an economic stimulus to jump-start the Japanese economy and stop the Asian economic downturn triggered by the currency crisis. It is going too far, however, to attribute the Japanese responses in 1998 exclusively to external pressure. The announcement of economic measures in 1998 was almost simultaneous with the demands of other countries, implying that the measures were voluntary rather than forced. Indirect evidence can be found in the fact that even the Diet, which is usually indifferent to external economic conditions, was eager to have Finance Minister

Matsunaga Hikari attend the G7 meeting in April, when the Diet was in session. The absence of ministers because of international meetings usually worsens sentiment in the Diet. This time, members of the opposition criticized the government because the finance minister skipped the G7 meeting to attend the Diet session. This was regarded as an expression of politicians' sense of crisis and their perception of Japan's adverse economic condition as a global economic problem, in sharp contrast to the situation in the 1970s and 1980s, when government officials were concerned about external economic considerations and were sensitive to external pressure, while Diet members were often critical of such attitudes.

Conclusion

More public and journalistic attention has been focused on international economic meetings, such as the G7 meetings and summits, in Japan than in any other country (Oshio 1999, 133–134). Government officials' public promises and other countries' demands on Japan have been extensively reported. This is considered a sign that Japan has been sensitive to external pressure. A brief examination of the way external pressure has worked from the 1970s through the 1990s, however, does not permit the easy generalization that Japanese economic policies are reactions to external pressure. It is true that policy changes have often been preceded by demands from other countries, most notably the United States, but this does not mean that external pressure makes Japan implement a policy that it would otherwise not implement. Rather, Japan voluntarily shifts to a policy based on the perception and anticipation of its own economic performance and global economic conditions.

Japan's good economic performance in the 1970s and 1980s was the reason external pressure appeared to be working. The United States legitimately demanded that Japan change its fiscal policy for the sake of global economic well-being because Japan was enjoying the fruits of international economic order at the expense of other countries, especially the United States. Japan could also afford to change its policy as demanded. Good economic performance made Japan respond to global economic conditions and also intensified external pressure. External pressure thus looked as though it were working on Japan.

The first major Japanese response to external pressure appeared to be at the time of the 1973 oil shock. Japan's economic performance after that oil shock was outstanding. Japan and West Germany were under strong pressure from other countries for fiscal expansion. Fiscal expansion was obviously not in Japan's own interest, witness the fact that Japan suffered large deficits in subsequent years, but Japanese policymakers complied as the duty of an economy that was performing well.

The dynamics of Japanese fiscal policy and external pressure in the 1990s demonstrate that poor economic performance delayed Japan's fiscal response to the global economic situation. Japan's economic performance began worsening in the early 1990s; for the first time in three decades, the performance of the United States exceeded that of Japan. In the 1990s, fiscal expansion was more necessary for Japan than for other countries. Despite this, U.S. pressure was less intense and Japan's response less sensitive than in earlier decades. This trend was especially apparent from late 1996 to early 1997, when the Japanese economic performance was improving and the budget deficit decreasing. With signs of economic recovery Japan quickly shifted from fiscal expansion to fiscal consolidation. As a result, Japan's response to the recession was delayed until 1998, when the government began massive and continuous infusions of money to stimulate the economy.

It is noteworthy that this shift corresponded with weakening pressure from other countries. Since Japan appeared to be on the road to economic recovery, the United States and other countries should have increased pressure to prevent Japan from shifting away from fiscal expansion. The United States as well as the European Union (EU) countries shied away from doing so, however, because they were afraid that Japan would point out their own inaction. The United States could not expand public spending, fearing both inflation and a budget deficit, and the EU countries could not because they had to hold down public debt to meet the criteria for participation in the EMU. These countries could have pushed Japan if its economic situation had been better than theirs, but given its poor performance, they feared that Japan might balk.

Seen in retrospect, the fiscal expansion in late 1996 and early 1997 was more consistent with both Japan's interest and global economic considerations than that during the post-oil shock period in the 1970s. The economic factor that differs most in the two periods is Japan's relative economic performance. In this regard, comparison of the two cases provides important evidence for the imperative of economic performance in determining the effect of external pressure on Japan. Another important factor that distinguishes the two periods has to do with party politics, that is, the stable one-party dominance before 1993 and the unstable coalition politics from 1993 onward. The volatile political situation was also a reason for the delayed economic response during the latter period. More precisely, during the period of unchanging LDP rule in the 1970s and 1980s, government officials could concentrate on coordinating policy in the light of global economic considerations, whereas political instability and poor economic performance delayed the implementation of an economic stimulus in the 1990s. Political instability worked in the same direction as the effect of economic performance on the behavior of government officials.

Japan is not a reactive state by nature. Until recently, Japan behaved as if it were reactive to external pressure because of its good economic performance. Good economic performance is likely to make a country vulnerable to demands from other countries whose performance is worse. If bad economic performance becomes the norm for Japan in the future, its economic policy will appear to be more independent from external pressure because Japan will not sensitively adjust policies to global economic conditions and other countries will rarely expect that Japan can afford to take action for the benefit of the global economy.

Notes

1. For the concepts of a public good and free riding, see Olsen (1965), and for their ramifications for the U.S.-Japan economic relationship, see Gilpin (1987).
2. See *Asahi Shimbun* 5 April 1992.
3. The general account is the total amount of government expenditure except that in special accounts that the government establishes for specific purposes. General expenditure is the amount that excludes bonds and local allocation tax from the general account.
4. The SDP underwent several name changes in the 1990s. Originally the Japan Socialist Party (Nippon Shakaitō), it changed its English name to the Social Democratic Party of Japan in February 1991. In January 1996, it changed its name to the Social Democratic Party (Shakai Minshutō). In this chapter I use the current name for simplicity's sake.
5. See *Asahi Shimbun* 22 January, 23 April, and 30 September 1996.
6. See *Asahi Shimbun* 11 January 1998, *Nihon Keizai Shimbun* 13 January 1998.
7. See *Asahi Shimbun* 18 January 1998.

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