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Ancient History

Practically every day, the *Wall Street Journal,* the *New York Times* and other papers solemnly announce that the U.S. dollar has reached a new post-World War II low against the Japanese yen. Actually they're wrong, because during most of the Occupation era the exchange rate was lower than it is today — although it changed sharply over time because of Japan's severe postwar inflation. Ancient history? Perhaps, but history that we would be wise to review, especially now that the shoe is on the other foot and the weakening currency is ours. The Japanese experience of the late 1940's shows us how rising prices and falling exchange rates go hand in hand, and more importantly, how that vicious circle can be overcome.

Disaster—and deficit financing

Japan's economy was smashed and truncated by World War II. Roughly 25 percent of her national wealth was destroyed, along with 30 percent of her industrial capacity and 40 percent of her urban area. Japan lost an empire but gained five million repatriates, and this helped push the broken nation's population up to 83 million, or 20 percent above the prewar figure. The nation's shipping was 80 percent destroyed, along with the bulk of her cotton-textile and chemical-fertilizer capacity.

In the crisis of peace as in the crisis of war, the Japanese relied heavily on government deficit financing to meet their needs, and these massive deficits were accompanied by a massive expansion of the money supply. Consequently, in the early postwar period, prices rose to more than 300 times the prewar level. In the words of a contemporary observer (Jerome Cohen), "It is a curious paradox that a country whose people are so devoted to frugality and thrift should have such a strong propensity to inflation as does Japan." But then, to help ease the inflation impact on producers and consumers, the government incurred more deficits through a vast program of subsidies, and the spiral kept going.

Inflation—and exchange rates

For the controlled economy of the Occupation era, a key problem was setting a viable exchange rate. Prior to the war, in the mid-1930's, the yen/dollar exchange rate was roughly 3.6 to 1 — but in 1945 the Occupation forces landed and set a military conversion rate of 15 to 1. With the surging inflation, the government raised the exchange rate to 50 to 1 in 1946, and then to 270 to 1 in mid-1948. Meanwhile, in the foreign-trade field, the Occupation developed a complicated system of implicit multiple rates for individual commodities.

The multiple exchange-rate system was administered by the Japanese Foreign Trade Board (Boekicho) and the Occupation bureaucracy. The Foreign Trade Board would purchase goods for export from a Japanese producer, paying him in yen his production costs plus profit — and would then sell the goods in world markets for the going price in dollars, paying those dollars into the Occupation's Dollar Trade Fund. If the Board paid ¥6,000 for a bicycle and sold it abroad for $20, it thereby established an implicit 300-to-1 exchange rate. If the bicycle producer's wage and raw-material costs rose

(continued on page 2)

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and the Board paid him ¥8,000, a 400-to-1 rate resulted.

Exchange rates thus varied widely from commodity to commodity. In late 1947, for example, yen/dollar rates ranged from 66 to 1 for canned bamboo shoots to 600 to 1 for lacquerware. It was a cumbersome system, with the bureaucracy pricing all exports commodity by commodity — and it was an incongruous system, with high-cost producers being rewarded at the expense of low-cost producers.

By subsidies and a multiple exchange-rate system, the Japanese producer became insulated from world market realities. His mounting costs thus helped bring about ever-larger government budget deficits, either through increased subsidies or through increased deficiencies in the Foreign Trade Board's accounts. By the 1949-50 fiscal year, price subsidies amounted to 29 percent of the government budget — the largest single expenditure item.

Enter Mr. Dodge

The U.S. government eventually called a halt, partly in an attempt to reduce U.S. subsidy payments of roughly $500 million a year, which went largely for the purchase of food and essential raw materials and fertilizer. In early 1949, the Detroit banker Joseph Dodge arrived on the scene, and his mission soon brought order out of chaos.

Mr. Dodge reasoned that to maximize Japanese exports, costs would have to be brought down to the point where Japanese selling prices equalled world market prices. To bring costs down, payrolls would have to be trimmed and prices stabilized. But to curb inflation, the budget would have to be balanced, subsidies ended, credit expansion checked, and a single exchange rate established. All this the Dodge Mission accomplished, and more. For example, the yen/dollar exchange rate was set at a realistic 360 to 1 — just about 100 times the prewar rate. Actually, only about 20 percent of Japan's exporting industries had been operating at higher exchange rates, so that most industries were not forced to incur severe cost reductions.

Many Japanese complained of tight money, stagnant output, rising unemployment, and rising business failures. (Indeed, many argued that the Japanese, as high-cost producers, could not compete in an unrestricted world market.) Yet the stabilization program was so effective that consumer prices dropped 17 percent between the spring of 1949 and the spring of 1950 — and real household consumption rose at that same rate.

Enter Mr. Yoshida

But then came Korea, and economists learned again that there are no final victories in the fight against inflation. The outbreak of Korean hostilities brought a halt to Japan's stabilization program and led to an export boom, materials shortages and renewed inflation. The U.S. "special procurement" program — Japan's Marshall Plan — helped cause a 60-percent increase in Japanese exports in the second half of 1950 and a 52-percent increase in industrial production between mid-1950 and mid-1951, but this welcome development was accompanied by a 52-percent rise in wholesale and a 90-percent rise in export prices. A world-wide commodity boom meanwhile

aggravated this price upsurge.

The war boom tapered off in 1952, only to be followed in 1953 by an import-led consumption boom. Industrial production jumped 24 percent in 1953, but at the expense of an upsurge in bank credit and a sharp decline in foreign-exchange reserves. The Yoshida government acted decisively at that point, however, and curbed the inflationary boom with a program of monetary and fiscal austerity. (Occupation control had ended in September 1951.) The feat was even more noteworthy, of course, considering that it was self-imposed rather than imposed from outside by Mr. Dodge.

The government sharply reduced public-investment spending, as well as long-term lending by the Japan Development Bank, and sharply tightened import-financing terms. This second dose of austerity set the foundations for a healthy economy – and the government successfully used the same medicine in the similar episodes of 1957-58, 1962 and 1965. Japan's industrial policies meanwhile encouraged firms to be efficient and to channel their energies into export markets – and the rest of the story we all know.

Lessons from the past

What lessons can we learn from this piece of ancient history? One thing we gain is an increased appreciation of the merits of a single fixed exchange rate, certainly in comparison with the Occupation era's complex and unworkable system of controlled rates. Yet the fixed exchange-rate system requires a certain amount of governmental self-discipline if it is to work properly. Not surprisingly, then, the stable 360-to-1 rate eventually developed serious faults of its own. Certainly it overvalued the dollar during the U.S.' Vietnam War inflation, and thereby helped set the stage for the breakdown of the old international system of fixed rates. A system of flexible rates apparently has become much more suitable for an era when different countries follow different inflationary paths.

The postwar episode also leads us to an increased appreciation of the merits of the old-time religion – fiscal and monetary tightness – for curbing inflation and stabilizing exchange rates. That medicine worked not only once but several times in Japan – under an outside regime in 1949, and under a purely Japanese regime in later decades. The policy shift thus helps to explain the contrast between the situation prevailing in the late 1940's, when most observers thought Japan had no economic future, and the situation prevailing in the 1970's, when just as many see Japan's future as practically unbounded.

Joseph Dodge revisited Japan in the midst of the Korean War to inspect his handiwork, and he was unhappy with much that he saw – including bountiful evidence of deficit financing, easy money and resurgent inflation. He thereupon lectured his hosts about 15 "dangerous delusions" which appeared to be sapping the strength of the national economy. One was the belief "that a rapid and excessive increase in domestic prices is inflation anywhere else in the world but not in Japan." By substituting another country's name for Japan in that sentence, we might see how relevant that warning is today.

William Burke