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Interwar Japan, Institutional Change, and the Choice of Austerity

Abstract: In interwar Japan the gold standard became conflated with austerity but, historically, there had been no such connection in Japan. Nineteenth and twentieth century British rhetoric made the gold standard an adjunct of deflation, but that was a British fixation, not Japanese. In addition to being highly political, this late-nineteenth century understanding and use of the gold standard was based on, and promoted, expansionary monetary policy and long-term development. In the interwar period this changed. Japanese governments chose austerity under the guise of complying with international rules and standards and turned the expansionary gold standard of the pre-World War I years into a deflationary system of austerity, depression, and, ultimately, nationalist reaction.

Keywords: gold standard, interwar Japan, austerity, monetary policy, economic institutions

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One attribute of the 2008 financial crash and its aftermath has been the policy prominence, particularly in Europe, of austerity in a recession – despite largely non-existent empirical and logical support, and underpinned primarily by cultural and character arguments. For historians this is remarkably reminiscent of the 1920s where policy decisions often made little sense in terms of economics, but instead rested on self-image, psychology, and an obeisance to contemporary convention in addition to the perennial division of particular groups seeking what they viewed as their own self-interest. The arguments then and now are remarkably consistent, and remarkably consistent in the groups and powers that they favor and disfavor as well as the results.

In the 1920s, principally in Japan and Britain, and then followed by Germany after 1929, austerity became associated with serious, responsible public policy although in practice it was nothing of the sort. Policy makers focused on the gold standard – the dominant international currency system from the

late-nineteenth century to the Great Depression, which had been suspended during World War I – both as a reason and as a means to promote austerity and economic recessions. In practice, the gold standard was driven – as the euro is today – by political, economic, and ideological forces far more complicated than appeals to economic science or policy inevitability (“there is no other choice”) imply. So why did and why do countries pursue austerity in response to economic downturns as occurred in the 1920s and after 2008 in contrast to the dominant, opposite impulse of the late-nineteenth century and the post-World War II years? And what, in particular, can Japan in the 1920s tell us about this process?

Taken to its extreme, interwar enthusiasm for austerity and deflation meant inducing a depression. In both Japan and Britain it reflected a consensus or orthodox view, a “gold standard ideology” or “gold standard mentality” that was a distinct product of the interwar years even as it harkened back to nineteenth and eighteenth century theory.¹ This gold standard ideology existed among financial, political, and media figures who took pride in being associated with what they presented as the respectable and sound views of Wall Street and the City of London.² Gold standard ideology, with its emphasis on austerity, deflation, and ironclad rules, dominated primarily in Britain, Wall Street, among the Austrian School (though with different emphases than the British version), and among part of Japanese society.³

The gold standard can seem quaint and distant in hindsight. It should not. Mechanically, it is little different from the post-World War II Bretton Woods system, the Asian and Latin American fixed exchange rate systems of the 1990s, and the European Monetary Union and euro, which to date has functioned less like a national currency than a gold standard style fixed exchange rate system. Similarly, what was most problematic about the gold standard in its interwar existence – an obsession with austerity, deflation, and the financial and ideological interests of the wealthiest slice of national populations, and the pretense

1 Temin 1989, Fukai 1938: 2. For a discussion of Fukai’s views, see Chô 2001 [1973]. For more on gold standard ideology, see Yeager 1984.

2 Inoue Junnosuke’s correspondence with J.P. Morgan & Co. in New York is replete with Inoue’s references to his belief in “sound” (in Inoue’s usage, deflationary) policies.

3 The fixation on preserving the then existing gold standard in Germany in the early 1930s and France into the mid 1930s rested on bases distinct from the 1920s British gold standard orthodoxy. The dominant concern was not to disturb the exchange rate that had been established with much difficulty in the 1920s. Banque of France officials in the 1920s, including the monetary economist Charles Rist, were well aware of the dangers of deflation, which they sought to avoid in setting the exchange rate for France’s return to the gold standard. See, for example, Rist 1924.

that this represented impartial science, natural necessity, and moral obligation – should be nothing new to observers of the present day world economy.

1 Interwar Japan and the gold standard

The interwar Japanese economy – and the global – has largely come to be defined in terms of the Great Depression and the gold standard, with the latter becoming linked as the primary factor producing the former.⁴ The gold standard, however, did not only exist in the 1920s, but worldwide from the 1890s including in Japan where it was adopted in 1897. Yet, the two systems – the 1890s and the 1920s – were notably different. Most importantly, the first was expansionary, the second contractionary – and intentionally so in both cases.

The gold standard was the system of pegging the value of national currencies to gold that came to prominence in the nineteenth century through happenstance, war, expansion of the British Empire, and then an array of nationalist and industrial promotion concerns in the late nineteenth century. The gold standard evolved historically through three phases, distinct geographically, politically, and economically. In the first phase, from the 1820s through the 1860s, gold was confined to Britain, Australia, Portugal, Brazil, and Turkey. The second phase began in 1873 when a newly unified Germany adopted the gold standard followed *de facto* by France. Finally, the 1890s saw the gold standard's third, and first genuinely global, phase as countries such as Japan pursued gold currency within the context of a new age defined by protectionism, industrial promotion, and colonial expansion, as well as lingering concerns from the 1870s and 1880s about the deflationary effects of appreciating currency. With World War I all countries eventually suspended gold convertibility, thus making return to the gold standard a symbol in the 1920s – as much political and psychological as economic – for returning to the presumed peace and prosperity of the prewar years: the idea of a lost (and, in large degree, imaginary) *belle époque* particularly powerful in Europe (struggling to recover from war) and Britain (struggling to preserve its empire and power politics role in the world).

The change in focus in Japanese economic policy after World War I from the industrial and military expansion of the 1890s to the contractionary austerity of the 1920s makes the 1920s idea of returning to the gold standard – *kinkaikin* or “lifting the gold embargo” in the language of the age – an oxymoron. Japanese proponents of returning to the gold standard advocated a nominally similar

⁴ See, in particular, Eichengreen 1992.

system to the prewar gold standard, but one that radically changed the nature, purposes, and effects of that system. The Japanese gold standard retained the same name, but its focus was new – and this novelty reflected changes both in Japan and the international environment. In short, the prewar gold standard in Japan was a primarily national system based on national goals and national interests. The postwar gold standard in Japan was viewed by its advocates as an international system, needed not for strictly national purposes or national welfare but, instead, in compliance with international norms and international institutions over which Japan had little, if any, influence.

The economic and historical debate about the yen's role in Japan's interwar depression and post-1932 recovery has been remarkably uncontroversial. The decision of Japan's Finance Minister Takahashi Korekiyo of the Seiyūkai to leave the gold standard and let the yen freely depreciate in 1932 has always been part of what Keynesian era observers argued were anticipatory Keynesian policies in Japan.⁵ In line with the shift from Keynesian economics, particularly in the United States, since the 1970s, economic discussions about Takahashi economics and Japan's relatively quick recovery after leaving the gold standard have instead tended to become centered on how much, if any, influence fiscal spending under Takahashi had with that recovery.⁶

Nakamura (1971) has emphasized fiscal stimulus, monetary easing, and yen depreciation as one combined policy. Nanto and Takagi (1985) and Okura and Teranishi (1984) emphasize yen depreciation. Cha (2003) focuses on fiscal policy, which he finds essential, but also emphasizes the positive effects of yen depreciation. Iida and Okada (2004) emphasize the role of inflationary expectations stemming from leaving the gold standard and the Bank of Japan's announcement of monetary easing. Umeda (2006) emphasizes overseas prices and the exchange rate. Shizume (2009) argues that the yen depreciation was notably more important than fiscal policy.

None of these works has disputed at least some effect of the yen's depreciation in Japan's recovery from the Great Depression. Nor is this simply a question of hindsight. When Japan went back onto the gold standard in early 1930 – after the 1929 Wall Street crash – the chosen exchange rate was universally accepted

⁵ Smethurst 2007 follows in this tradition.

⁶ A central aim of the attack on Keynesianism – and return to nineteenth century English theory – being to show that government spending (fiscal policy) is ineffective and that economic policy should focus on monetary policy (through independent central banks) as well as shifting from promoting demand through direct payments to individuals to promoting supply through aid to companies (cutting taxes, regulations, labor laws).

in Japan as being overvalued and requiring significant deflation to enact and sustain.

But beyond purely technical issues, Japan's two gold standards – prewar and interwar – reflect broader alternation between expansionary and contractionary economic policy and the political parties and social groups promoting and benefiting under one or the other system. As Mark Metzler discusses, Japan's modern political parties developed as part of an alternation between expansionary and contractionary economic policy.⁷ Specifically, the Seiyūkai and its supports favored an expansionist “positive” or “active” policy (*sekkyoku seisaku* 積極政策) reminiscent of post-World War II Keynesianism while the Kenseikai and its successor Minseitō focused on austerity: fiscal and monetary retrenchment (“negative” or passive policy (*shōkyoku seisaku* 消極政策)). One can see a similar distinction today between the Liberal Democratic Party's more expansionist *abonomics* and the budget balancing emphasis of the Minshutō (DPJ) – with both parties across the board roughly matching bases of support and policy inclinations with those of the Seiyūkai and Minseitō.

In rough trajectory with the ascendancy of one or the other party and the interests they represented (farmers, banks, debtors, creditors, export industry, import industry, great power wars, colonial expansion, treaty diplomacy) economic policy shifted between expansion and contraction with an expansionary wartime and postwar boom from 1904 through 1906, retrenchment from 1907 to 1915, renewed expansion from 1916 to 1920, on and off contraction through the 1920s in anticipation of “returning” to the gold standard, contraction and austerity from 1929 through 1931 as the gold standard was reintroduced at the prewar exchange rate, and then expansion as the yen was allowed to float freely from 1932 – which was, in turn, made more expansionary by increased government development expenditures (fiscal policy) and then increased military expenditures especially from the mid-1930s.⁸

In the 1920s the Seiyūkai's expansionary policy was embodied by Takahashi Korekiyo, who served first as Governor of the Bank of Japan and then, repeatedly, as Finance Minister. Kenseikai/Minseitō austerity became associated with Wakatsuki Reijirō, Hamaguchi Osachi, and Inoue Junnosuke. Wakatsuki and Hamaguchi were career officials in the Finance Ministry before joining the Kenseikai/Minseitō and serving as Finance Minister, Home Minister, party president, and Prime Minister. Inoue started at the Bank of Japan and served as

⁷ Metzler 2015.

⁸ Although fiscal policy, military expenditures tend to be excluded from fiscal policy discussions and standard budgeting concerns in countries assigning heavy political and/or ideological weight to the military and military action.

Governor of the Bank of Japan before becoming Finance Minister and then Minseitô president.

In addition to expansion versus contraction (austerity) the prewar and interwar Japanese gold standards also differed in terms of nationalism versus internationalism (or an ostensible internationalism of implicit national Anglo-American dominance) and the interwar's adoption of other elements of the British theoretical heritage common from the 1980s onwards as well: rules rather than discretion, and free trade rather than protectionism.⁹ As part of this rules-based (and, in practice, contractionary) thinking the gold standard was presented as a straightjacket restraining governments, rather than a discretionary tool to be used by governments for national ends as in the prewar period.¹⁰ Britain in the final years before World War I came closest to this fictional view. But as economists and historians such as Barry Eichengreen and Arthur Bloomfield have shown, even Britain was not immune from fiddling with the rules and intervening in exchange markets in the late-nineteenth century.¹¹

As much as the gold standard was an international monetary institution establishing a common global reference for international trade and finance, it was also originally an explicitly national institution and flowed out of efforts in the nineteenth century to create national currencies. Under centralized government control, these currencies replaced the more flexible and borderless currencies of the pre-nineteenth-century world such as Mexican silver, which had dominated in Asian trade.¹² Most notably, governments established central banks simultaneously with expansion of the gold standard.¹³ They used these banks to control financial flows, which under English liberal theory were supposed to occur automatically and free from state control. The State Bank of Russia (1860), the German Reichsbank (1876), the Austro-Hungarian Bank (1877), the Bank of Japan (1882), and the Bank of Italy (1893) – all were part of

9 In practice, despite the clarity of ideological rhetoric no country was ever fully rules-based or fully discretionary, fully free trade or full protectionist. And, often, such as in mid-nineteenth-century Britain the tools of one (free trade) could be used for the ends of the other (protectionism).

10 1920s style rules ideas gained prominence again starting in the 1970s in reaction to discretionary Keynesianism dominant from the 1930s through the early 1970s. For this renascent rules literature, see Kydland/Prescott 1977, Lucas 1976, and Barro/Gordon 1983. For rules interpretations of the gold standard, see Bordo/Rockoff 1996, Bordo/MacDonald 1997, Bordo/Kydland 1995, 1996, and Bordo et al. 1999.

11 Eichengreen 1987, 1992, Bloomfield 1959, 1963.

12 For the nationalization of currency in the nineteenth century, see Helleiner 2003. On Asian currencies, see Wolters 2005.

13 On the relationship between central banks, the gold standard, economic nationalism, and activist state policy, see De Cecco 1974, Helleiner 2002, 2003.

the process of monetary consolidation and control that continued with adoption of the gold standard.¹⁴

In many respects the situation in Japan in the 1920s was similar to that in Britain, where policymakers spent a decade deflating the economy for the sake of returning to the gold standard at the prewar exchange rate (or ‘par’ or ‘parity’), with severe effects on industry and employment. In Britain, old par enthusiasts based their beliefs on the interests of debt holders and recapturing prewar British financial and political pre-eminence. The latter, they believed, with little evidence, rested on returning to the gold standard at the prewar exchange rate.

In Japan, however, old par enthusiasts were not looking to recapture lost influence. On the contrary, Japan’s political and economic position strengthened as a result of World War I. Heavily indebted at the start of the war, by 1919 Japan had turned from a net debtor to net creditor and its economy was in the midst of new and heavy industrialization. Instead, old par enthusiasts in Japan saw austerity and deflation both as ends unto themselves and as means to return to what they viewed as Japan’s true economy after the ‘false’ years of the wartime and post-war boom.

2 Currency appreciation, deflation, panics, and depression

The causal relationship between currency appreciation, deflation (or disinflation), and, in the extreme, recession and depression is a standard part of economic theory. Appreciating currency does not always mean deflation just as depreciating currency does not always mean inflation – and in non-extreme amounts and depending on the circumstances may be beneficial. But the general logic – and dominant logic of the post-World War II years – is that policy should act counter-cyclically to expand the economy in recessions and dampen demand if inflation becomes too great. Less logically consistent is the reverse course of contracting the economy when inflation is not excessive or when the economy is already in recession – in effect, the logic of 1920s (or 2010s) austerity.

¹⁴ Central banks were expected to work with the government (or were part of the government) and in many cases (such as the Bank of France) in part funded the government. The implementation of independent central banks is part of the anti-Keynesian, neoclassical turn from the 1970s and geared, primarily, to promoting low inflation rather than employment.

In interwar Japan the connection between yen appreciation and deflation stands out. Looked at over the course of the 1920s, the yen's appreciation was consistently followed, with a delay, by price declines. New par advocates were particularly concerned that the deflation rate was larger than the rate of yen appreciation. That is, there was a multiplier effect: a given amount of appreciation produced an even greater amount of deflation. From 1924 through 1928 the yen appreciated 13.5 per cent against the dollar, while prices declined 17 per cent.¹⁵ From 1925 through 1928 the yen appreciated 11.6 per cent while prices fell by 17 per cent.

The yen's appreciation also correlated with Japan's repeated financial panics of the 1920s. The pattern was consistent: austerity and appreciation to return close to the prewar par, panic, retreat from austerity, compensatory measures from the Bank of Japan and/or government, followed by depreciation. And then the cycle would commence again. Far from financial panics being a *deus ex machina* interrupting an otherwise smooth appreciation of the yen, as portrayed by old par advocates particularly outside of Japan, appreciation itself was a major factor behind Japan's financial panics, including the largest of them in 1927.

In this way arguments that 'if only x, y or z had not happened in the 1920s, Japan would have smoothly returned to the gold standard' miss the point that x, y and z were almost always tied to attempts to return to the gold standard at the prewar par. Although the yen's appreciation from 1925 onwards was not the only factor in bringing about the 1927 financial panic, the Kenseikai/Wakatsuki cabinet's moves toward lifting the gold embargo at the prewar parity were the most fundamental cause, with the key factor being deflation from and for currency appreciation.¹⁶ As appreciation and deflation continued exports and economic activity decreased and debt burdens and bankruptcies increased.¹⁷ The logical alternative was to lift the gold embargo immediately but at a devalued exchange rate. As of 1929, however, when the return to the gold standard was finally decided, that was still a minority opinion.

There was nothing to prevent a government from reactivating the gold standard at an exchange rate different from that used prior to World War I. In Japan the prewar exchange rate of 1 yen to US\$49.85 had been in effect for eighteen years.¹⁸ There was no particular sense in assuming that an exchange

¹⁵ *Tôyô keizai shinpô* 4/1929: 12.

¹⁶ *Tôyô keizai shinpô* 4/1929: 13.

¹⁷ Developed most famously by Fisher 1933, debt deflation is a standard concept in economic literature that discusses how deflation increases the real amount of money that debtors owe.

¹⁸ Suzuki 1929: 49.

rate roughly reflecting the state of the economy, and its position relative to other countries, in 1897 should be the same eighteen years later given continual changes in trade, growth, population, and industry. In addition there were the enormous changes brought by World War I: an export and industrial boom, financial speculation, inflation, post-war agricultural surpluses and price declines, speculative bubbles, and a fundamentally reordered Japanese and world economy.

One possibility was to lower the official parity to the most recent market exchange rate – which for Japan in early 1929, the year the Minseitô government forced through return to the gold standard, would have been approximately US\$45.¹⁹ This was essentially what France, Italy, and Germany had done. In this way the exchange rate could be stabilized without changing relations between debtors and creditors and without causing real tax burdens to increase. Fixed exchange rates would provide a stable base for businesses to budget costs and revenues. Businesses could then invest and trade without fear of losses from fluctuating exchange rates.

But for Inoue Junnosuke, a product of the international banking community and notably anglophile, forcing through return to the gold standard at the prewar exchange rate represented both the fulfillment of the Minseitô's main economic plank and emulation of Britain's return to the gold standard. Inoue, though, was hardly a lifelong advocate of deflation. Inoue was a vocal advocate for returning to the gold standard at the prewar exchange rate throughout the 1920s. But as Governor of the Bank of Japan and during his first term as Finance Minister, Inoue had a reputation for being financially practical and not particularly ideological. During the post-panic, 1927 currency appreciation the Bank of Japan – with Inoue as Governor – lowered interest rates expressly to prevent deflation.²⁰

Upon returning as Finance Minister in 1929, however, Inoue insisted on immediately reinstating the gold standard at the prewar par. Though generally regarded in the U.S. and Britain as liberal due to his support for the gold standard and close relations with Wall Street and the City of London, Inoue was not above using the Tokyo police to intimidate those he viewed as undermining the gold standard by selling yen and purchasing dollars. Inoue made deflation a national mass movement from mid-1929 with anti-consumption campaigns, police suasion, and public denunciations of trading firms choosing to purchase dollars rather than yen. The day before the gold standard went into effect on January 11, 1930, the Finance and Interior Ministries had the main

19 Uenoyama 1/1929: 16.

20 *Tôyô keizai shinpô* 4/1929: 12.

Tokyo stock and currency traders called into police headquarters for a lecture on their duties to support Japanese financial markets.²¹ Inoue also joined nationalist groups in their public denunciations of Japanese currency traders buying dollars as being un-patriotic.

In addition to Inoue, advocates for reinstating the prewar exchange rate fell into four general categories. First were deflation enthusiasts who argued for the ostensibly competitive benefits of deflation, ‘liquidation’ (*seiri*), and ‘rationalization’ (*gôrika*). For them the boom years of World War I were not a benefit, but a curse because industries had been coddled as if in a “greenhouse” and their success represented a “false balance sheet” that could only be “true” if subjected to the prewar exchange rate.²² Closely connected with these, and in many cases overlapping, were economic moralists who claimed that saving, suffering, and retrenchment reflected and promoted national and individual character. Third were those who viewed the exchange rate as symbolic of national worth. Even the otherwise skeptical Vice Governor of the Bank of Japan Fukai Eigo argued that it would be useful to adopt the prewar exchange rate in order to avoid the damage to Japanese self-esteem in being associated with the devaluing countries of Germany, France, and Italy.²³ The main Tokyo and Osaka newspapers, in particular, stressed the loss of national honor that would result from failure to return to the gold standard at the prewar exchange rate. For them devaluing the currency was tantamount to devaluing national status.

3 The *Kinkaikin* problem

Occasionally viewed as a decade of deflation, stagnation, and economic distress, the Japanese economy in the 1920s consisted of wildly differing sectors. Some were stagnant, others expanding. GDP growth, except when compared with the exceptionally high rates of World War I and equally pronounced growth after 1932, was hardly anemic.

Deflation was not a serious problem until governments from the mid-1920s adopted it as official policy. From 1926, first under the Kenseikai Finance Minister Naoharu Kataoka, and then more intermittently under the Seiyūkai Finance Minister Mitsuchi Chûzô, governments began preparing for a return to

²¹ *Tôyô keizai shinpô* 1/18/1930; *Tôyô keizai shinpô* 1/25/1930: 7. On frugality campaigns, see Metzler 2004 and 2006, and Garon 1997 and 1998.

²² Morita 1929: 67, 69.

²³ Uenoyama 3/1929: 47.

the gold standard at the prewar exchange rate. But in Japan the enthusiasm for austerity and deflation most notable in the Kenseikai and Minseitô came unaccompanied by the vague longing for glories past that drove Britain's return to its overvalued, prewar exchange rate. Even with Japan's postwar bubble having burst in 1920, Japan's economy in the early 1920s was fundamentally stronger commercially, industrially, and financially than in the years before World War I. Rather, the impetus for returning to the prewar exchange rate in Japan came primarily from Japan's largest banks and other financial institutions, urban political parties most closely tied with these institutions, and the daily press.

Old par advocates in the interwar years, in their emphasis on a supposed immutable value of gold across the war years, neglected that gold prices fluctuated significantly during the nineteenth century. They also neglected that worldwide expansion in the 1890s and early 1900s was in large part a monetary phenomenon linked to increased gold production.²⁴ In the 1890s as countries worldwide moved to the gold standard, that standard had become inflationary rather than deflationary in marked contrast to the gold-standard-linked deflation of the previous twenty years.²⁵

In the early 1880s Japanese governments induced deflation to deal with rampant inflation from the late 1870s.²⁶ But there was a difference between prices in 1870s Japan and 1920s Japan. Japanese prices declined from 1925 even prior to the Minseitô's deflation campaigns.²⁷ At the end of December 1924 the wholesale price index was 229. By March 1929 it had dropped to 178.²⁸ By 1929 there had been four years of moderate deflation, particularly felt in Japan's agricultural villages. Prices were largely stable since mid-1928. Inducing more deflation in order to reach the prewar exchange rate meant destabilizing the economy rather than stabilizing it.

But despite continuing deflation the Kenseikai/Minseitô, banks, and the daily press talked much about the need for "liquidation" (*seiri*) and "austerity" (*kinshuku*). By the late 1920s it had become a standard trope in which the presumed need for "liquidation" and "austerity" were invoked without explaining why they were necessary beyond a presumed need to return to the gold standard at the prewar exchange rate. It was never explained why the gold

24 Uenoyama 3/1929.

25 For how gold's turn to being an expansionary standard encouraged states to adopt the gold standard, see Flandreau et al. 1998.

26 See Ericson 2014.

27 *Tôyô keizai shinpô* 5/1929: 10.

28 *Tôyô keizai shinpô* 5/1929: 10.

standard had to be reactivated at the prewar exchange rate except for those, going full circle, who claimed it was to promote liquidation and austerity.

To the extent that returning to the prewar exchange rate was justified as a prerequisite to contraction and austerity, the argument became circular. Contraction and austerity were needed to return to the prewar exchange rate, which was needed in order to promote contraction and austerity. The same rhetorical slight of hand functioned in simultaneously arguing that the gold embargo could be lifted at the prewar exchange rate because contraction and austerity had been completed and then advocating a vast campaign of contraction and austerity in order to support the newly installed gold standard.

Contraction and austerity were interchangeably used as prerequisites, duties, rationales, means, and ends in a series of arguments that never ultimately answered why contraction and austerity were beneficial or necessary. As the journal *Tôyô keizai shinpô* remarked, the words liquidation and austerity were “invoked as if chanting a prayer” but never explained or justified.²⁹

4 The expansionary prewar

The gold standard that Japanese supporters in the 1920s claimed they were reintroducing was not the same gold standard that Japan had enacted in 1897. There were significant differences between how the gold standard functioned – and what motivated it – in Japan prior to World War I and how its advocates in the 1920s believed or claimed.

Despite concerns about a deflationary gold standard, the gold standard did not need to be deflationary. In Meiji Japan currency rates were accepted as tools to other ends. No one with any influence in Meiji Japan argued that currency had an innate, natural value that existed outside the control of governments and that could only be expressed in terms of gold. In this view, any governmental attempt to alter the exchange rate from an exact substitute of one unit of paper to one unit of gold was both against nature and an illegitimate exercise of governmental power. Since none of these nature-of-money arguments carried weight in Meiji Japan, setting the exchange rate became a practical matter of weighing the costs and benefits of potential rates. This meant in practice deciding whether the exchange rate would be at the still legally existing rate from the prior 1871 Currency Law or whether the gold rate would be devalued to compensate for two and a half decades of falling silver prices relative to gold.

²⁹ *Tôyô keizai shinpô* 5/1929: 10.

If one adopted the dominant view taken in the 1920s that the pre-existing exchange rate was sacrosanct, the answer would be to keep the 1871 rate and induce a depression in order to force the economy to deflate to the old exchange rate. Why someone would want to do this was another question entirely. But unlike in the years after World War I, the most recent point of reference for governments in the 1890s was the deflation of the 1880s, not inflation. Japanese governments in the 1890s were more concerned with promoting industrial expansion than they were with the cult of induced deflation that developed around the gold standard after World War I.

A state orientation toward industry and economic expansion did not mean that devaluation was a given. There existed a range of opinions regarding the specific exchange rate that could be set. Debtors, creditors, farmers, different industries, exporters, importers, banks, and various journalists, politicians and bureaucrats representing one or more of these groups all had their preferences for the exchange rate.

The Finance Minister Matsukata Masayoshi ultimately devalued the gold exchange rate in Article 2 of the Currency Law fifty per cent from what it had been under the 1871 currency law.³⁰ The 1 gold equals 32.3 silver rate that Matsukata established in the Currency Law was meant to reflect the existing 1:28 Japanese market rate – as opposed to the 1:16 rate in the 1871 law – thereby leaving the price level and debt relations unchanged, plus an extra margin to allow for potential silver depreciation in the future.

Above all, Matsukata emphasized the need to avoid larger economic and social changes as a result of currency changes. The point was to avoid unnecessary shocks to the economy and to prevent changes in the relative economic positions of different groups merely through currency changes.

5 The contractionary postwar

Suspension of the gold standard worldwide with World War I led to a significant increase in Japan's overseas gold reserves. By the late 1920s, however, as these reserves dwindled there developed an exaggerated sense of time pressure to do something about returning to the gold standard.

Once the yen's value began plummeting from 1921 arguments emerged that the Japanese price level was too high compared with the rest of the world. The

³⁰ See Matsukata's March 3, 1897 Diet speech where he explains how the specific exchange rate was calculated. Matsukata 1899.

argument was, essentially, that an import surplus meant prices were too high and only by lifting the gold embargo could those import surpluses be erased. But the argument, even on the most abstract level, only made sense if one accepted eighteenth century theory about the automatic workings of the gold standard as an actual description of reality. Regardless of the price level, Japan needed to import large amounts of materials unavailable in Japan to rebuild after the 1923 Tokyo earthquake. Nor had the nineteenth century gold standard ever meant, except in theory, that countries on a gold standard had perfectly balanced trade and did not chronically run import surpluses as Japan had in fact done prior to World War I.

But even if this presumed automaticity of the gold standard were the goal, the particular price level at which one adopted, or reactivated, the gold standard made no difference. If one did not particularly care about lifting the gold embargo at the prewar exchange rate, the issue became one of devaluing the exchange rate to accommodate the actual price level. Absent hyperinflation that carried costs entirely separate from the trade balance, there was no practical reason to assume that the price level was a problem or that the price level should necessarily change rather than the exchange rate.

A great many people, including academics, editorial writers, bankers, politicians and bureaucrats cared about lifting the gold embargo at the prewar exchange rate even if they did not present a rationale for that exchange rate beyond assuming that deflation in and of itself enhanced “competitiveness” (*kyôsôryoku*). As with so much else in the austerity debates of the 1920s the idea of competitiveness – and its vague and generalized use – forms a central part of the present day euro debate as well. If one, however, accepted that Japanese prices were higher than those in the United States or Britain (though less than those in France and Germany) and that this was somehow a problem, there were three methods advanced to push Japanese prices down.

First, one could lift the gold embargo according to the classic eighteenth century, David Hume, specie flow mechanism argument that gold would immediately flow out forcing the domestic price level down to its presumed natural level consistent with the prewar par. In theory as well as practice, however, this meant prompting a recession and very likely a financial crisis as well. If one wanted gold standard orthodoxy, then this was the logical option.

But even the most die-hard advocates of the prewar exchange rate did not take Hume’s theory to its logical conclusion that, merely by lifting the gold embargo at the old exchange rate, prices would quickly and efficiently ratchet downwards. Instead, supporters emphasized the need to push the price level down before lifting the gold embargo. Yet they most often did so simultaneously with the argument that lifting the gold embargo itself would push prices down,

mixing the two issues and effectively proposing two measures that risked circulating about each other until each became a prerequisite for the other.

This contradictory, before-after, condition-consequence mix of deflation arguments gave an otherworldly quality to the debate. On the one hand, old par proponents argued that the time was ripe for lifting the gold embargo, and it could be accomplished with minimal pain, because the price level had already dropped. On the other hand they also argued that upon lifting the gold embargo mass mobilization efforts would be necessary to force down the very same prices that had ostensibly already declined in order to sustain the gold standard.

The second way to reduce prices relative to those of other countries was the exact opposite of returning to the overvalued rate and letting the real economy adjust. Instead, one could allow no payments in gold whatsoever: no gold exports and no payment from overseas gold reserves. Instead, the exchange rate would fall where it would. Price competitiveness would be obtained not through austerity, but through allowing the exchange rate to depreciate to whatever level it would without state intervention. This would lower relative export prices and feed an export boom as during the war. Inukai Tsuyoshi's Seiyūkai cabinet under Minister of Finance Takahashi Korekiyo followed this option from December 1931 in going off the gold standard. The resulting yen depreciation and export boom – with or without public works and military expenditures – is generally seen as pulling Japan out of its gold standard induced depression.³¹

The third possibility advanced at the time was to worry about both domestic and export prices and simultaneously try to inflate and deflate the economy. That is, allow no gold exports or drawing down of specie reserves as Takahashi Korekiyo pursued after 1931 in order to devalue the exchange rate and spur exports while, simultaneously, reducing the money supply domestically in mimicry of government policy of the early 1880s. This third possibility is, in essence, what is now called “expansionary austerity” and is similar to what was supposedly followed in Sweden and Canada in the 1990s: i.e., combine domestic austerity with currency depreciation and expanded exports. The key historical and empirical point, though, is that austerity is only expansionary if accompanied by currency devaluation. Without devaluation, austerity is simply austerity.³²

³¹ See Nakamura 1971, Nanto/Takagi 1985, Okura/Teranishi 1994, Cha 2003, Iida/Okada 2004, Umeda 2006, and Shizume 2009.

³² On expansionary and non-expansionary austerity see Gavazzi and Pagano 1990, Alesina/Ardagna 1998, 2009, Guajardo et al. 2011, International Monetary Fund 2012, and Blanchard/Leigh 2013.

Prior to the end of 1931, however, neither the Seiyūkai nor Kenseikai/Minseitō cabinets clearly chose any of these options. Even Inoue Junnosuke's rushed move to lift the gold embargo in 1929 was a stopgap affair wherein Inoue swung wildly between trumpeting "natural" market mechanisms and seeking state control over those same forces when the outcomes did not match what he had imagined. The natural market mechanisms – i.e., the movements of the yen absent state efforts to control the yen's value – of 1920s Japan were for the yen to depreciate, not appreciate as Inoue and the Kenseikai/Minseitō wanted. The Seiyūkai, meanwhile, preferred to fudge the issue in an attempt to save gold reserves for use in China.³³

There was also among the Kenseikai/Minseitō the idea that political internationalism would save economic internationalism. In this view, the Washington Conference System – the core of the Kenseikai's policy of "Shidehara Diplomacy" – would establish a world standard not only for military reductions, but also for global currency policy.³⁴ Whereas the Seiyūkai declined to lift the gold embargo in 1919 out of a desire to pursue its own foreign policy and economic objectives in China, the Kenseikai/Minseitō were paralyzed by their reliance on Anglo-American institutions and agreements. This reliance became an excuse for inaction until Inoue frantically moved to return to the gold standard at the prewar exchange rate in late 1929 just as the New York Stock Exchange collapsed.

The second, and simplest and easiest, option – letting the exchange rate depreciate – carried the least weight for reasons that, if ever expressed, were more psychological than economic or empirical. For proponents of the prewar exchange rate, depreciation was to be avoided precisely because it *was* the simplest and easiest option – implying assumed moral failure, lack of character or loss of international prestige. For example, the Bank of Japan's Vice Governor Fukai Eigo argued that devaluation would damage Japanese self-esteem since Japan would then be analogous to France and Italy rather than Britain and the United States who did not.³⁵ For old par advocates, failing to make the effort necessary to return to the prewar exchange rate indicated a character weakness and inability to endure hardship that would turn Japanese society into a nation of weaklings. In this view devaluation "results in people running away, avoiding all difficulty and easily giving up." This, in turn, was a problem of "modern social conditions" that were "ever speeding up" and "ever more shallow."³⁶

³³ On plans for a yen bloc including China, see Schiltz 2012.

³⁴ Ishibashi 1929: 23.

³⁵ Uenoyama 3/1929: 47.

³⁶ Obama 1929: 63.

This refusal to let the exchange rate depreciate resulted from 1925 onwards in the government consistently paying down its remaining overseas reserves in order to prop up the yen as close to the prewar exchange rate as possible. The Ministry of Finance and Bank of Japan could still replenish these overseas reserves even with the post-1920 trade deficits – and partially did so earlier in the 1920s – through foreign loans. But this inevitably pushed the question of the gold standard's suspension to the fore and, by 1929 when the reserves were virtually exhausted, almost inevitably meant dealing definitively one way or another with lifting the gold embargo and the entire issue of the gold standard – the “*kinkaikin* problem”.

By 1929 the declining state of overseas reserves, if not an insurmountable technical problem – as they could be refilled although with various economic permutations and consequences – was, however, a looming political issue and came to be viewed, reasonably or not, as a ticking clock setting a limit on the time available to reinstitute the gold standard.³⁷

6 *Kinkaikin* problematizers

Returning to the gold standard became a problem in the 1920s because people made it a problem – and they made it a problem through austerity. There were reasons to want to stabilize the exchange rate through fixed exchange rates and an international currency system. But from the mid-1920s the desire for stability was replaced as the driving force of returning to the gold standard by a desire to reinstate the prewar exchange rate for the sake of reinstating the prewar exchange rate and an almost obsessive desire to throw the economy into a depression.

For many of the most enthusiastic proponents of returning to the gold standard at the prewar exchange rate, reactivating the gold standard was not the end goal itself. It was, instead, a means to austerity and contraction. Reinstating the gold standard by the late 1920s in Japan became a means for those who wished to deflate the economy in pursuit of “liquidation,” “austerity,” and the “competitiveness” this was supposed to produce, as a means to strengthen national character or in simple adherence with the supposed international “rules of the game.” For the most influential supporters of the prewar exchange rate, deflation was not a side effect of returning to the gold standard. It was the purpose.

³⁷ Ishibashi 1930: 21.

The divisions over the gold standard were not, however, along left-right lines. Rather, there were two sets of divisions – practical versus theoretical (with the inevitable blurring between the two: one’s pragmatism is another’s ideology; pragmatism itself is an ideology), and interest group divisions. As seen by Akamatsu Katsumaro of the Social Democratic Party (Shakai Minshûtô) the situation was little different from that as seen by the more classically liberal Ishibashi Tanzan of the *Tôyô keizai shinpô*, his more critical colleague Takahashi Kamekichi or almost any industrialist, including Mutô Sanji of the textile firm (and export dependent) Kanebo.

Doctrinal Marxists agreed that deflation and returning to the gold standard at the prewar exchange rate would be disastrous. But, like deflation proponents who welcomed the coming competitive effects of depression, they too welcomed the coming disaster. For Japanese Marxists who believed the destruction of capitalism was both inevitable and desirable, lifting the gold embargo at the prewar parity meant little but a “contradiction of capitalism”: a self-defeating course that would speed the destruction of capitalism. Much as Marx had announced his support for free trade in the mid-nineteenth century believing it would speed capitalism’s end, Japanese Marxists in the 1920s looked forward to returning to the gold standard at the prewar exchange rate as proof of the futility of the capitalist system.³⁸

Supporters of the prewar exchange rate saw things differently. The first point of the austerity/prewar exchange rate triangle was the banking industry. Bankers generally favored immediately lifting the gold embargo at the prewar exchange rate because it increased the value of their loans and yen-based assets, and increased their purchasing power overseas. But Japan’s banks balked when the inevitable depression threatened their own interests. Repeatedly during the 1920s, the main Tokyo banks called for immediate return to the gold standard and then pulled back when moves to do so led to interest rate increases, stock and bond collapses, and financial panics. Japan’s banks wanted to return to the gold standard at the prewar par until governments actually began moving in that direction. The banking industry would either then retreat from the idea of immediately returning to the gold standard or would demand financial assistance that made returning to the prewar exchange rate essentially meaningless.

Representatives of industry, particularly the silk and textile industry, supported reinstating the gold standard at the prewar exchange rate in order to stabilize exchange rates and promote exports in the early 1920s. They shifted, however, to fierce opposition in the late 1920s when it had become apparent that

³⁸ Akamatsu 1929: 48. Marx 1848.

the prewar exchange rate would damage exports, raise interest rates, and produce a depression. Mutô Sanji of Kanebo, Kagami Kenkichi of Tokyo Marine Insurance, and Yano Kota of Daiichi Life Insurance all supported devaluing the exchange rate by 1929. Nowhere was the change in opinion more pronounced than with Mutô who shifted from being a strong supporter of immediate return to the prewar exchange rate in 1924 to equally strongly supporting devaluation in 1929.³⁹

Japan's new industries established during the war – and benefiting under depreciated exchange rates – also fiercely opposed returning to the prewar exchange rate. With World War I there had been a burst of new businesses and expansion of old: iron, steel, machinery, leather, chemical fertilizers, dyes, glass, paper, and various chemical industries.⁴⁰ Except for paper manufacturing, all were infant industries and had largely developed since the gold standard was suspended in 1917 due to the natural protection provided the depreciating exchange rate. This mirrored development of the textile industry in the 1890s, which benefited from depreciating silver and then was further protected by Matsukata's devalued exchange rate in the 1897 Currency Law.

At the end of 1928 the Industry Club of Japan (*Nihon kôgyô kurabu*) issued a report estimating the effects of lifting the gold embargo at the prewar par on various industries. It showed major losses for all industries. The report estimated particularly large losses for the iron/steel, chemical fertilizer, and electrical machine industries.⁴¹ Except for internal industry reports, however, there was little study – by Inoue, the Minseitô, the Bank of Japan or the daily newspapers – of the effects on industry of reinstating the prewar exchange rate. In contrast to the debate on the gold standard in the 1890s – where the focus was on industry, commerce, and exports – in the 1920s the center of the gold standard debate shifted to banking and financial interests and largely ignored industry.

The second point of the triangle advocating deflation and the prewar exchange rate was the major daily press. The *Osaka Mainichi*, *Osaka Asahi*, *Tôkyô Nichinichi*, and *Tôkyô Asahi* were the most enthusiastic in favor of the prewar exchange rate. The largest dailies – *Osaka Asahi* with 1.26 million readers, *Osaka Mainichi* with 1.16 million, *Tôkyô Nichinichi* 450,000, *Tôkyô Asahi* 400,000 – were all enthusiastic supporters of deflation.⁴²

In contrast to the largest dailies, the *Tôyô keizai shinpô*, its editor Ishibashi Tanzan, and the economic journalist Takahashi Kamekichi were the most

³⁹ *Tôyô keizai shinpô* 2/1929: 9.

⁴⁰ Obama 1929: 62.

⁴¹ Obama 1929: 62.

⁴² For circulation figures, see Yamamoto 1981.

persistent in arguing for devaluation. By 1929 Obama Toshie of the *Chugai Shôgyô Shinpô* and Yamazaki Yasuzumi of the *Yomiuri Shinbun* also joined calls for devaluing the exchange rate. Far from being a gold standard opponent, Ishibashi Tanzan was an outspoken supporter of Matsukata's gold standard and fiercely critical of then Finance Minister Takahashi Korekiyo for not lifting the gold embargo in 1919 at the prewar exchange rate. Contrary to Matsukata in the 1890s, Ishibashi was fundamentally a proponent of English political economy, but this did not change his support for devaluation by the late 1920s.

Ishibashi regretted that Inoue Junnosuke and others had become obsessed with reinstating the form of Matsukata's gold standard rather than the spirit. He regretted that they insisted on ignoring the changed economic circumstances between 1899 and 1929. In particular, he objected to their fixating on the particular exchange rate contained in Matsukata's Currency Law rather than the idea underlying it – setting an exchange rate reflecting existing economic conditions.⁴³ For Ishibashi, Matsukata's success in adopting the gold standard was two-fold: adopting the prevailing world standard, and then tailoring it to Japanese needs – the classic Meiji strategy. Matsukata took the form of prevailing international rules, but then adopted them to Japanese conditions: rules plus discretion, not rules rather than discretion.

The final, and most important, point of the triangle was the Mitsubishi-financed Kenseikai and then Minseitô, with their urban, financial industry base. As discussed above, the Kenseikai/Minseitô Finance Minister Inoue Junnosuke personified the gold standard as deflation approach in interwar Japan. Most striking was Inoue's personal investment in the issue from 1929 onwards. Even as Britain abandoned the gold standard in September 1931, and Japanese soldiers rebelled simultaneously in Manchuria, Inoue refused to reconsider returning to the gold standard at the old exchange rate. Even as the economy quickly recovered under a depreciated yen from December 1931 Inoue remained a fierce critic of this abandonment of austerity until his assassination two months later by nationalists accusing him and a list of other austerity-era politicians and wealthy bank and corporate heads of selling out Japan, economically and politically, to foreign interests.

Chô Yukio and Richard Smethurst have argued that Inoue by 1929 was driven in part by ego and desire to become Prime Minister in a Minseitô cabinet.⁴⁴ Mark Metzler is more forgiving, seeing Inoue as sincere in his belief in austerity and contraction.⁴⁵ Metzler also cites pressure from U.S. bankers to

⁴³ Ishibashi 1930: 16.

⁴⁴ Chô 2001 [1973]: 79–82, Smethurst 2007.

⁴⁵ Metzler 2002, 2006.

return to the gold standard at the prewar par. Although true that U.S. bankers often pushed Japan to return to the gold standard at the old par, by 1929 they were alternately praising Inoue's retrenchment policies and recommending, tolerating, and/or leaving the decision regarding devaluation for the Minseitō government to decide.⁴⁶

The economics were not mysterious. Devaluation, in addition to being at the heart of Japan's adoption of the gold standard prior to World War I, was followed by any number of countries in the interwar period, including Germany and most successfully France. By the time Inoue's old par gold standard commenced in January 1930, it was already common knowledge in Japan and elsewhere that Britain's return to the gold standard at the old par in 1925 had been a mistake and France's 1928 devaluation successful. France would only suffer when it insisted on keeping its gold standard (and thus, by then, overvalued currency) through the mid-1930s as other states abandoned the gold standard and let their currencies depreciate.⁴⁷ Other opinions existed, but they did not change Inoue's move to reinstate the gold standard at the prewar exchange rate.

7 Conclusion

Japan's return to the gold standard implicated two interrelated problems. The first was the insistence on inducing deflation and economic depression for the sake of returning to the gold standard at the prewar exchange rate, and the simultaneous use of the gold standard as an excuse for independently desired austerity. The second problem was governmental policy that sought affirmation overseas and among a small subsection of the most well off members of

⁴⁶ Thomas Lamont papers, Harvard Business School Library. See J.P. Morgan internal memo dated June 7, 1929 in which Morgan Partner Lamont states that "stabilization should be effected at or even a little below the present exchange value of the yen". See also letter from Lamont to T. Haraguchi, Japanese Financial Commission, October 4, 1929: "High money rates in New York and London will, of course affect the movement of funds to and from Japan and the bond market here. If, therefore, Japan were to decide that, in view of the credit strain and dear money rates in London and New York and elsewhere, it would be better for her to suffer some considerable depreciation of the yen and reflation of domestic prices, that would be an understandable decision...The Japanese authorities themselves are the only ones who can form an adequate opinion about political, social and economic conditions in Japan and whether these are such as to make the moment opportune for stabilization and what the rate of stabilization should be."

⁴⁷ On France, see Mouré 2002.

Japanese society rather than among the broad mass of the country. Growth not first rooted in austerity was viewed as not true growth (the metaphor of the greenhouse or false balance sheet). Meanwhile, the failure of austerity to produce its advertised results was presented as all the more reason to continue (there being no other choice, one must try still harder).

Austerity as national policy was particularly problematic in Japan in the 1920s where unemployment was chronic and excess population became an obsessive concern fuelling immigration to Latin America and the United States as well as expansion in Manchuria. With Japanese immigration cut off by the U.S. Congress in 1924, and gold austerity-induced depression at home, the most appealing option became emigration to Manchuria, which had been a focus of Japanese businesses, investors, and government entities throughout the 1920s.

When the Minseitô government refused to expand Japanese control in Manchuria during the 1931 height of Japan's gold standard depression, Japanese army units took control themselves. This military rebellion, by troops primarily from Japan's most impoverished regions, ushered in establishment of the Japanese protectorate Manchukuo, and a series of assassinations, attempted coups, and military governments in Tokyo. The Minseitô government and Inoue Junnosuke, though, largely ignored the rural poverty that was fuelling military unrest. Instead, they concentrated on making Japan a subordinate member of an Anglo-American financial and military order. On the military side was the Washington Conference System, which set 5:5:3 and 10:10:7 rates for various types of U.S., British, and Japanese naval vessels. On the economic side was the gold standard and imitation of 1920s British austerity.

It was only with the fall of the Minseitô government in December 1931 that austerity was finally abandoned. But if Inoue was particularly stubborn in his views, he was hardly unique in his obsession with austerity and the self-image he constructed for himself as the courageous bearer of universal, internationally sanctioned, scientific truth. In this Inoue was as much a product of his time and social stratum as Matsukata Masuyoshi in the 1890s had been of his.

Although it is now generally considered standard in English-language literature to link adherence to the gold standard and the Great Depression this is, ultimately, a story based on (or supporting) an expansionary, macro, demand-based reading of economics (with or without the label Keynesian) refracted through a particular reading of World War II and its causes, and a concern for certain interests over others.

The Inoue/austerity view reflects its own tradition and interests – a story that emphasizes inflation rather than deflation, and focuses on the early interwar and the 1970s, rather than the late interwar, and supply rather than demand. One can see both these expansionary and contractionary views in the

popular, political, and economic arguments and action about present-day austerity and the euro. Which, in turn, contrary to any reading of the gold standard or the interwar years as historical relics, underlines how interlinked Japan has been for most of its modern history with institutions and ideas in the rest of the world, and how little those institutions and ideas – and the interests and impulses that underlay them – have changed over time, in Japan or elsewhere.

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