The Bank of Japan – Institutional Issues of Delegation, Central Bank Independence and Monetary Policy

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von
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List of Abbreviations

ABCP = Asset-backed commercial paper (*shisan tanpô komâsharu pêpâ*)
ABS = Asset-backed securities (*shisan tanpô shôken*)
ADL = Anti-Deflation League (*defure dakkyaku giren*)
ARPH = Administrative Reform Promotion Headquarters
BIS = Bank for International Settlements (*Kokusai Kessan Ginkô*)
BOC = Bank of Canada
BOE = Bank of England
BOJ = Bank of Japan (*Nippon Ginkô*)
CBSG = Central Bank Study Group (*Chûô Ginkô Kenkyû Kai*)
CEFP = Council on Economic and Fiscal Policy (*Keizai Zaisei Shimon Kaigi*)
CGPI = Corporate goods price index
CLB = Cabinet Legislation Bureau (*Naikaku Hôsei Kyoku*)
CPI = Consumer price index
DPJ = Democratic Party of Japan (*Minshutô*)
ECB = European Central Bank
EPA = Economic Planning Agency (*Keizai Kikaku Chô*)
ESA = Economic Stabilization Agency (*Keizai Antei Honbu)*
ESRI = Economic and Social Research Institute (*keizai shakai sôgô kenkyû jo*)
ESS = Economic Scientific Section
ETF = Exchange traded funds
FDI = Foreign direct investment
FED = US Federal Reserve System
FEFSA = Foreign exchange funds special account
FM = Finance Minister
FRC = Financial Reconstruction Commission (*kinyû saisei iinkai*)
FSA = Financial Services Agency (*Kinyû Chô*)
FSRC = Financial System Research Council (*Kinyû Seido Chôsa Kai*)
GDP = Gross domestic product
IBJ = Industrial Bank of Japan (*Nippon Kôgyô Ginkô*)
IMES = Institute for Monetary and Economic Studies (*Nippon Ginkô Kinyû Kenkyû Jo*)
IR = Interest rates
IT = Inflation target (*infure tâgetto*)
JBIC = Japan Bank for International Cooperation (*Kokusai Kyôryoku Ginkô*)
JCCI = Japan Chamber of Commerce and Industry (*Nihon Shôkô Kaigisho*)
JRP = Japan Renewal Party (*Shinseitô*)
JT = Japan Times
LDP = Liberal Democratic Party (*Jiyû Minshutô*)
METI = Ministry of Economy, Trade and Industry (*Keizai Sangyô Shô*)
MOF = Ministry of Finance (*Ôkurashô, Zaimushô*)
MPM = Monetary Policy Meeting
NCP = New Conservative Party (*Hoshutô*)
ODR = Official discount rate (*kôtei buai*)
PB = Policy Board
PRC = Policy Research Council
PT = Project Team
QEP = Quantitative easing policy (*ryôteki kanwa seisaku*)

REIT = Real estate investment trust
SCAP = Supreme Commander of the Allied Powers
SDP = Social Democratic Party (*Shakai Minshutô*)
ZIRP = Zero interest rate policy (*zero kinri seisaku*)

1. Introduction

The institutional design of central banks and monetary policy are of great interest in academic literature. Japan is of particular interest for economists, because Japan has been confronted with the problem of deflation since the late 1990s. In response to this problem, the Bank of Japan (BOJ) introduced unconventional tools of monetary policy such as zero interest rates and quantitative easing. The BOJ did so as a legally independent central bank, for the Japanese Diet enacted a new Bank of Japan Law (BJL) in June 1997, which came into effect on 1 April 1998. This new law granted the BOJ independence, and ended the era of a central bank which was legally dependent on the Government and the Ministry of Finance for over half a century.

Section 1.1 examines this thesis' research questions further. The organisation of this thesis is presented in Section 1.2.

1.1 Research Questions

The question of how to design central banks has been the subject of substantial political and economic disputes for a long time. There is a worldwide trend of governments to grant independence to their central banks. However, central bank independence is a complex and multifaceted institutional design. As a result, central banks have been analysed by numerous academics from different fields, first and foremost, by economists. Later, studies were complemented by (comparative) political economists, political scientists and even sociologists. However, despite the large amount of literature about central banking and monetary policy, central bank independence has been dominated by an English or Anglo Saxon viewpoint (Toniolo 2010: 28), neglecting peculiar characteristics of specific countries. This thesis adds a viewpoint from Japan and tries to contribute to the discussion of central bank independence by means of an in-depth analysis of the institutional issues of the Bank of Japan.

Most papers about the Bank of Japan have focused on the subject of monetary policy, in particular the zero rate interest policy and the quantitative easing policy, and which effect these policy measures had on the Japanese economy. One set of studies provides advice about the optimal monetary policy in a deflationary environment. This dissertation will not investigate the issue of optimal monetary policy – there are dozens

of studies which have already concentrated on this subject.[1] Rather, this study focuses on central bank reform and the institutional design of the Bank of Japan, analysing and interpreting both its de iure and de facto central bank independence. In other words, this thesis is a positive analysis as to how the central bank is designed, and which effect the Bank of Japan law revision had on the BOJ. This must be kept strictly separated from a normative analysis of how the central bank should be designed, or which effect a change should have.

Regardless of the law revision and the Bank of Japan's higher de iure independence since 1998, one important question is whether the BOJ really is independent in a de facto sense. One might argue that the Bank of Japan is independent only by statute in a legal sense. For instance, assuming that the Bank of Japan is independent, why has the Bank of Japan Governor had to be a permanent member in the 2001 government established CEFP (Council on Economic and Fiscal Policy)? Or, why did politicians from the LDP's "Committee for Investigation of Financial Problems" (*jimintô kinyû mondai chôsa kai*) decide to establish a working group that investigates issues of central bank independence and inflation targeting, and even submitted a bill to the Diet to re-revise the Bank of Japan Law? In this context, it is essential to understand what Japanese politicians aimed at when revising the BJL and what their perception of what an independent central bank is or should be. This dissertation will investigate the delegation to an independent Bank of Japan, and provide case studies in order to understand the resulting relationship of the Bank of Japan with the government and politicians.

This thesis has three pillars: The first deals with the question of political delegation and answers the question why the BOJ was granted independence. The existing literature on central bank reform does not fully explain why the Bank of Japan Law was revised in 1998. Although there was no persistently high inflation in Japan, and the reduction of inflation was viewed as the main merit of an independent central bank, politicians decided to grant independence to the Bank of Japan. Finding alternative explanations for central bank law revision in Japan is a primary objective of the thesis.

[1] For a survey, see for instance, Bernanke et al. (2004); Eggertson and Woodford (2003); Iwamura et al. (2006); Oda and Ueda (2007).

The second subject is a de iure analysis of the new Bank of Japan Law, concentrating on an investigation of central bank independence. This subject includes an examination of central bank accountability and transparency. The third pillar presents case studies which analyse how the BOJ interacts with the government and politicians, and tries to answer the question whether the BOJ is de facto independent.[2] The objective of this dissertation is not only to identify who and what made central bank reform possible, but also to find out why this reform occurred at this particular time, why it was enforced as it was, and why the result was like it was and not different. The overall objective of this dissertation is to contribute empirically to the understanding of central bank independence based on an analysis of the Bank of Japan. To sum up, this thesis pays special attention to following questions:

1. Why was the Bank of Japan Law revised in 1998?
2. What exactly was changed in the Bank of Japan Law? How did central bank reform affect the Bank of Japan's independence? (de iure analysis)
3. How did the new law change the Bank of Japan's independence and its relationship to the government and Diet politicians in reality? Did the BOJ decide over monetary policy independently? (de facto analysis)

According to Yin (2009: 9), "why" and "how" questions are explanatory, and lead to the use of case studies as the primary research method. Taylor (2009) argues that "[a] case study approach appears to be the most appropriate means of identifying the "causal paths and variables leading to the dependent variable of interest", in this dissertation the central bank independence of the Bank of Japan. In other words, the case study method is a useful tool in this thesis to provide answers concerning the process of choosing, designing, and implementing a fundamental institutional change (BOJ Law revision) in a complex organisation such as the Bank of Japan. In addition, how both the BOJ and political actors interpreted the new institutional design of the BOJ will be demonstrated. The methods used in this thesis and the framework of how to answer these research questions will be provided in Chapter 2.

[2] This thesis focuses on the time period since the beginning of the "new" Bank of Japan in 1998 until 2012, which means most recent developments of the BOJ under Kuroda Haruhiko, who was appointed by Prime Minister Abe Shinzô in 2013, will not be considered.

1.2 Organisation of the Dissertation

This dissertation contains 9 chapters, which are organised as follows. This introduction includes the background and purpose of the study, research questions, and the organisation of this thesis.

Chapter 2 provides the theoretical framework for the analysis and interpretation of the central bank independence of the Bank of Japan in the following chapters. This study adopts a mixture of two analytical methods of the new institutional economics, namely that of principal-agent theory and a historical institutionalism approach. This dissertation analyses the delegation to an independent Bank of Japan, the appointment of BOJ Governors, and monetary policy decisions of the BOJ by means of a principal-agent model with multiple principals.

Chapter 3 analyses the process of the Bank of Japan law reform. First, the establishment of the Bank of Japan and the Bank of Japan Law of 1942 will be briefly elaborated. Afterwards, an analysis of why previous attempts of law reform failed will be of interest. The most crucial part of this chapter is the process of law reform between 1996 and 1998, which will be discussed in detail. Subsequently, the role of the most important actors will be elaborated in order to draw conclusions about incentives and motivations of central bank reform in Japan. This chapter distinguishes the actors between the Bank of Japan, state actors, and private actors. State actors are the Ministry of Finance and political parties, including the Liberal Democratic Party, the New Party Sakigake and the Social Democratic Party. Private actors are interest groups such as the financial sector.

Chapter 4 focuses on the decision made by politicians which aimed to yield authority over monetary policy to an independent central bank. A primary goal of this study is to empirically find out which factors explain central bank reform in Japan. That is, this thesis aims to examine the theoretical understanding of the delegation of regulatory competencies to independent agencies, here the independent Japanese central bank. This chapter seeks to explain the origins of central bank reform in Japan by utilizing a principal-agent perspective that focuses on the incentives of political actors. In order to identify why central bank reform in Japan happened in 1998, it is essential to concentrate on the question of who brought about the Bank of Japan Law revision.

Finding answers to this research problem involves an analysis of the institutional design of central bank independence.

This chapter tries to form a link between theory and empirics. First, this chapter lists and analyses existing delegation theories. After that, these theories are applied to Japan. Additionally, some alternate explanations, such as a bureaucratic approach and the concept of ideas, are added. The examination of various factors on the national level aims to explain the timing and the Bank of Japan's path to central bank independence. In other words, Japan was selected a crucial case study to test contending explanations of central bank reform. The Japanese case is an exceptional paradigm for studying the delegation of central bank independence.

Chapter 5 focuses on the de iure outcome of the Bank of Japan Law revision. The issue of central bank independence on the basis of the Bank of Japan Law will be investigated. This chapter includes a description of the Bank of Japan Act from 1942, followed by a more detailed investigation of the new 1998 Bank of Japan Law. The second main area of focus contains a summary of the most essential contents, and an examination of various features of central bank independence. On the basis of this analysis, this thesis aims to demonstrate that the Bank of Japan Law includes various weaknesses in regards of central bank independence. In a following section, the most important central bank independence indices are introduced, including an evaluation of the Bank of Japan's independence.

Chapter 6 investigates the issue of central bank transparency and accountability. The development towards greater central bank independence is directly related and complementary to the subject of accountability and transparency. This thesis elaborates definitions and features of both concepts. After this general investigation, characteristics of the Bank of Japan's accountability and transparency are analysed. In a final section of this chapter, indices of central bank accountability and transparency are investigated, and critically applied for the Bank of Japan.

Chapter 7 turns to a de facto analysis of the Bank of Japan and provides details of the BOJ regarding its strategic relationship with the government. The focus in this chapter is the "old" Bank of Japan law, and elaborates the system of alternating BOJ governors,

temporary assignment of MOF staff in the BOJ, and the role of the MOF as a safeguard for the BOJ.

Chapter 8 will analyse the de facto central bank independence of the new Bank of Japan, focusing particularly on governmental and political pressure exerted on the central bank. Basically, there are two sets of political influence exercised by the government and politicians on a central bank. The first one is via the appointment procedure of the central bank's key staff, and the second one is via the interference in the monetary policy decision-making process. This chapter presents a detailed analysis of the Bank of Japan for both subjects. The appointment process will be elaborated, and hereby concentrate on the three Governors of the newly independent central bank, namely Hayami Masaru, Fukui Toshihiko and Shirakawa Masaaki. In addition, the appointment of Deputy Governors and deliberative Policy Board members will also be considered. The second channel of interference is the subject of monetary policy. This thesis works out the main events of monetary policy decisions since 1998. Pressure from the government and Diet politicians on the Bank of Japan will be analysed in detail in order to gain insights of the BOJ's de facto independence.

Chapter 9 is the concluding chapter and provides a summary of the empirical findings of this dissertation. This chapter also discusses recent developments and future implications for the Bank of Japan.

2. Methodological Approach and Theoretical Framework

2.1 Introduction

This chapter builds the theoretical framework which will be used to analyse and interpret the central bank independence of the Bank of Japan (BOJ) in the following chapters. This dissertation is based on empirical research, and it is an in-depth case study of the Bank of Japan which contributes to the discussion of the institutional design and independence of the Japanese central bank. Contrary to most studies on central bank independence, this thesis adopts a qualitative methodology. Based on qualitative methods, the political economy of delegation and central bank independence of the Bank of Japan will be investigated. This thesis follows a methodology which focuses on choices and strategies of politicians in order to explain delegation to an independent central bank. In subsequent chapters, case studies are presented in the following two dimensions: the appointment procedure of BOJ Governors and that of monetary policy decisions. These case studies aim to understand the de facto relationship between the BOJ, the Japanese government, and politicians. This thesis employs a two-layer analytical framework, namely a principal-agent model and a historical institutionalism approach which will be discussed in the following.

2.2 Principal-Agent Theory

Principal-agent theory can be classified as a branch of rational choice theory. The general aim is to explore issues of "institutional design under conditions of imperfect information" (Pollack 1997: 101). Regarding delegation, the principal-agent theory argues that rational actors delegate power to agents in order to reduce the transaction costs of policy-making (Pollack 2007: 3). Most generally, principal-agent relationships start "whenever one individual depends on the action of another" (Pratt and Zeckhauser 1985: 2). This means that principal-agent theory can be employed in many different fields which are characterised by a hierarchical relationship between actors. Principal-agent theory became very popular and influential. Moe (1984: 757) stresses the strength of this framework and argue that principal-agent theory "cuts through the inherent complexity of organisational relationships by identifying distinct aspects of individuals and their environments that are most worthy of investigation, and it integrates these elements into a logically coherent whole". In short, principal-agent framework is useful for investigating real world problems, such as relationships between doctor and patient, employer and employee, depositor and bank, or government and bureaucracy. This

means that principal-agent models can also be employed to understand complex issues such as central banks and governments in regards of delegation and monetary policy decisions.[3]

2.2.1 Principal-Agent Theory of Central Banks and Monetary Policy

Rational choice theory dominates the literature on the politics of central banks (Bell 2002; Cukierman 1992), and principal-agent theory has become a common tool to investigate the strategic relationship between central banks and the government, or politicians (see, for instance, Fratianni et al. 1997), or optimal contracting for central banks (Walsh 1995a, 1995b, 1995c).

The ultimate principal is the society, or the voting public, which prefers low inflation rates in the long run, and stable macroeconomic conditions on whole. The existing literature assumes that there is no conflict of interest between the government and the public. As a consequence, most models of central bank independence replace the general public with the government as principal. The society, via the government, provides the central bank – the agent – with the task to achieve its preferred target of low inflation. The details of the arrangement are manifested in a contract, the central bank statute.[4] However, there is an important point which describes the relationship between the principal and the agent. Due to the central bank's expertise and direct contacts with financial institutions, the relationship is characterized by asymmetric information. This opens the possibility for the central bank to implement new strategies and to seek own policy goals that are incoherent with the principal's goals (Bofinger et al. 2001: 168-169; Fratianni et al. 1997; Illing 1997: 224-225).

In sum, principal-agent theory is a useful tool to analyse both the delegation of monetary policy to an independent central bank and the relationship of central banks and the government.[5] However, it is possible for a principal-agent framework to be

[3] In this regard, "the principal-agent approach is also useful for heuristic purposes. It establishes a framework to clarify particular issues. […] By focusing on the exercise of control within institutional arrangements, principal-agent theory forces attention to focus on positive rather than normative analysis" (Elgie 2002: 198).

[4] Principal-agent models have been applied to find the optimal mechanism of a central bank contract. With a delegation the principal (government) designed a "sophisticated incentive structure" (a contract) to accomplish optimal outcomes of monetary policy (Walsh 1995c).

[5] See, for instance, Elgie (2002).

characterized by multiple principals, and exactly this case is the subject of the following section.

2.2.2 Multiple Principals of a Central Bank

Many authors, who apply a principal-agent framework in models of central bank independence, work with one principal. For instance, Hüpkes et al (2005: 18) argue that "a central bank performing its monetary policy function usually does so under a delegation of authority from *either* the executive *or* legislative branch" [italics added]. However, there are two things wrong with the assumption of only one principal. First, it is problematic to apply models with a single principal to presidential systems. Second, case studies demonstrate that the power of the government (or president) and the Diet (legislative) differs between nations. As a result, delegation is usually made by multiple principals (Bendor, Glazer and Hammond 2001: 244-245; Shugart and Carey 1992).

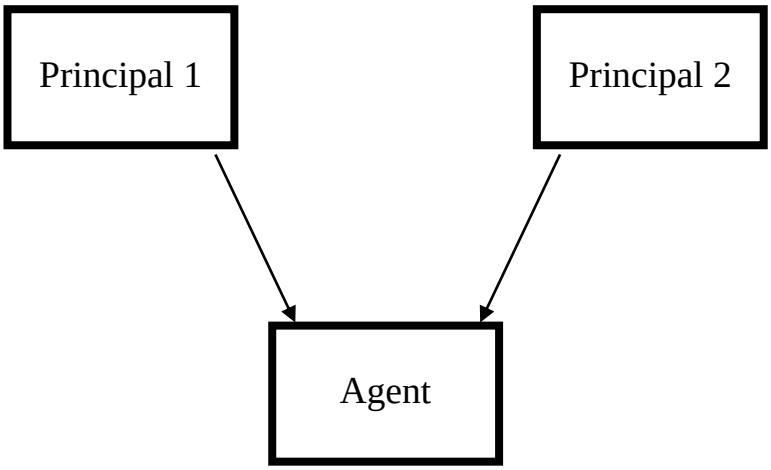
In regards of the appointment procedure and monetary policy decisions, the central bank statute defines the fundament of the strategic interaction between the government and politicians with the central bank. A legally dependent central bank is accountable to only one principal, the Cabinet. The Cabinet is wholly responsible for the appointment of the central bank's key staff. In contrast, an independent central bank usually must answer to more than one principal. The legislature can be seen as a second principal.[6] Usually, both principals share the power to appoint members of the central bank's monetary policy governing council. In addition, sanctions typically require the cooperation of both principals. For instance, changes made to the institutional design of the central bank – used as a threat by principals – require "the cooperation of both the Cabinet and a legislative majority" (Bernhard 2002: 29).

An independent central bank can be considered an independent agency, and it is useful to characterize the principal-agent relationship of central banks as having multiple principals. Unfortunately, up until now, there are only few authors, who apply a

[6] In this context, the central bank of Russia is an interesting case. According to various central bank independence measures (see, Chapter 5), the Russian central bank is evaluated as independent, because it is relatively independent from the government. However, de facto the Russian central bank is very dependent to the Parliament (Banain, Burdekin and Willett 1995). In conclusion, it is not enough to solely analyse central banks in their relationship to the executive branch.

multiple principal framework to central banks, including Bernhard (1998, 2002)[7] and Oritani (2010). A principal-agent framework with multiple principals has already been applied to the US Federal Reserve. Morris and Munger (1998) investigate the politics of the Federal Reserve with multiple principals, the Congress and the President. Similarly, Havrilesky (1995) distinguishes between the pressure upon the US Federal Reserve by the executive branch (chap. 2, pp. 28-82) and the legislative branch (chap. 3, pp. 83-117). In a similar vein, Morris (2002) analyses the policymaking of the Federal Reserve in interaction with Congress and the President by means of a multi-institutional approach. Figure 2-1 offers a simple model of a principal-agent framework with multiple principals.

Figure 2-1: Principal-Agent Model with Multiple Principals



Source: Own illustration

However, there are considerable disadvantages for multiple principals which result in higher costs, e.g., the cost of monitoring and coordination is considerably higher (Kassim and Menon 2003: 124-125). A similar argument is made by Dixit (1996), who argues that the agent may suffer from a low-incentive problem due to multiple principals, or slightly different, the agent has "low-powered incentives". In this case, the agent can "challenge the Cabinet's policy choices" (Bernhard 2002: 17), or needs to

[7] Bernhard (2002: 45-55) develops a game theory model of the monetary policy process build of three players: the government, the central bank, and the legislator. The model is characterized by asymmetric information. In contrast to backbench legislators, the central bank and the Cabinet ministers have expertise in monetary policy.

satisfy only one principal, making it easier for the agent to follow own policy goals. This has consequences for the central bank and its strategic behaviour. The central bank can increase its independence by playing off the two principals.

For example, regarding sanction measures, in case of misconduct by the central bank, the Cabinet can punish the central bank only by collaborating with the legislature. As a result, central banks need to appeal only to one principal, either the Cabinet or the legislature, to resist pressure from the government, or to avoid changes to their institutional design (Keefer and Stasavage 2000; Morris 2002). This fact provides the central bank with more room to manoeuvre in the monetary policy making process (McCubbins, Noll, and Weingast 1989). When confronted with political pressure, central banks can make use of enhanced transparency and publications (Chapter 6). For example, they can publish disputes with the principals, particularly with the Cabinet, in order to disregard politicians, or to explain their policy decisions. In addition, central banks may direct attention towards policy mistakes made by the Cabinet, or to politicians, in case they are exerting too much influence on the central bank (Bernhard 2002: 29-30, 57).

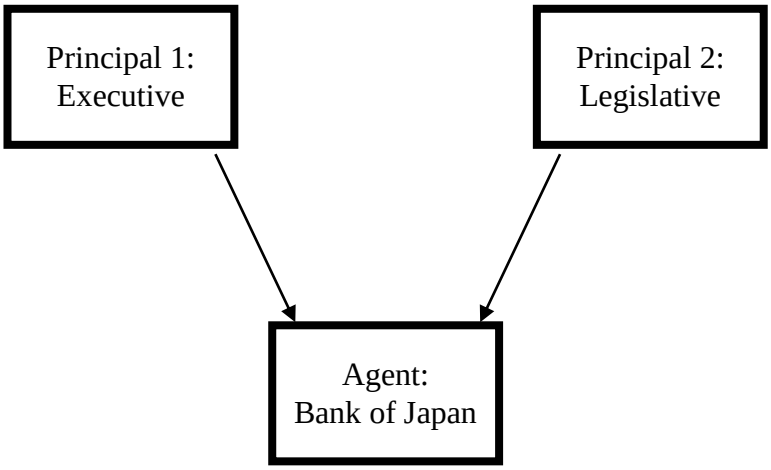
Having taken the above mentioned information into account, this thesis employs a principal-agent framework with multiple principals, namely one which includes the legislative and the executive branches of the government. In comparison to those models which employ only a single principal, this framework is seen as a more accurate methodological approach to analyse the political economy of the Bank of Japan in regards of delegation, the appointment procedure, and governmental influence in monetary policy decisions.

2.2.3 A Principal-Agent Framework of the Bank of Japan

Figure 2-2 presents a simple model of the Bank of Japan and two principals: the executive (Government/Cabinet) and the legislative (Diet politicians) branch of the government.[8] In Chapter 8, a more detailed principal-agent model is presented.

[8] For a first application of a principal-agent framework and the BOJ, see Pascha (2005a). Pascha (2005a) develops a three-stage principal-agent framework to explain delegation and monetary policy of the newly independent BOJ. Bebenroth and Vollmer (2007) compare the BOJ with the ECB referring to a principal-agent model.

Figure 2-2: Principal-Agent Model with Multiple Principals and the Bank of Japan



Source: Own illustration

This theoretical set-up offers a good foundation when trying to understand the motivation of the actors, and provides insights into the relationship between the Bank of Japan and the government, or politicians. Furthermore, it provides information suitable for assessing the extent to which the Bank of Japan has developed own goals and interests. This thesis applies a principal-agent framework to the following three areas of interest:

1.) Delegation of power to an independent Bank of Japan
2.) An analysis of case studies, concerning the appointment procedure of the Bank of Japan's key staff
3.) An analysis of case studies, concerning governmental pressure and monetary policy decisions

1. Delegation

In a principal-agent framework, delegation of decision-making powers means that the principal (government) chooses to delegate power to an agent (central bank). Pollack (2007:8) argues that principal-agent theory "provide a useful starting point for theorizing about both delegation decisions and subsequent relations between principals and agents – including the possibility that agents like courts or central banks enjoy extensive discretion from their principals." However, there are two crucial conditions

for the principal to delegate power to an agent. First, there is the expectation that the actions of the agent will coincide with the preferences of the principal (the ally principle). Second, there is the belief that there are benefits for the principal. In short, the principal-agent framework identifies the rationale why principals choose to delegate (McNamara 2002: 50; Gilardi 2007: 304-307).

2. The Appointment Procedure

This section analyses the appointment procedure of the Bank of Japan's key staff, in particular the Governor. In this analysis, the government plays the main role, as, according to the Bank of Japan Law, the government is in the position to appoint the central bank Governor. However, the appointment is subject to the consent of both houses of the Diet, i.e. the second principal has veto rights. The analysis of politicians' choice of a particular Governor is the key question in this section. It is impertinent to note that the right of appointment of the Governor, Deputy Governor, and Policy Board deliberative members is an important factor of influence, and represents a possible form of pressure exerted by politicians on the central bank (Chang 2003; Capie et al. 1994: 55).

3. Monetary Policy Decisions

The third aspect focuses on the conduct of monetary policy decisions, and, here, the agent – the Bank of Japan – is legally in the position to decide monetary policy. This means that the agent makes the first move, and the principals can only respond afterwards, e.g., with sanctions and threats. In this analysis, confrontations between the BOJ and the government or politicians are a frequent phenomenon. In case studies, a principal-agent framework is a powerful tool to illustrate that both the Bank of Japan and the government have intrinsically sound positions. First, from the perspective of the government, principal-agent theory can demonstrate that the agent (the BOJ) is shirking, and, thus, acting in an undemocratic manner. It can be argued that the BOJ has taken its secondary objective of monetary policy insufficiently into consideration, namely to support the general economic policies, and to continue "contributing to the sound development of the national economy" (Article 2 and 4 of the new Bank of Japan Law). In contrast, principal-agent theory can also be applied to show the viewpoints of the agent. BOJ officials claim that the Bank is independent (Article 3) and may argue that the preferences of the principal have changed, and some politicians would prefer a

dependent central bank.[9] In fact, this thesis demonstrates that politicians and BOJ officials have different preferences. Comparing the government's position with actions of the BOJ using a principal-agent framework helps to clarify the conflicting logics that support the positions held by the both actors. In short, principal-agent theory helps to gain an understanding of the debate surrounding the institutional design of the BOJ, and helps to explain BOJ's actions regarding monetary policy decisions.

In order to understand the path towards central bank reform and institutional issues of central bank independence in Japan in detail this dissertation employs a second analytical tool, namely a historical institutionalism approach.

2.3 Historical Institutionalism Approach

Originally, the historical institutionalism approach[10] was derived from political sociology and political science, by authors such as Peter A. Hall and Kathryn Sikkink (Blyth 1997). Later, this approach was identified as an analytic tool and area of the new institutional economics (see, e.g., Richter and Furubotn 2003: 40-43). One important agenda of research is the theory of constraint, that is, "its explanation of how ideas and institutions limit the range of possible solutions that policy makers are likely to consider when trying to resolve policy problems" (Campbell 1998: 378). Steinmo (2008) argues that the historical institutionalism approach is characterized by a focus on "real-world empirical questions" and contributes to explanations to which "institutions structure and shape behaviour and outcomes." Therefore, this approach is well-suited to analyse the political economy of delegation and central bank independence.

Many studies about central banks focus on quantitative methods. This has the advantage to allow large-scale comparisons, in particular in the construction of measures of central bank independence. However, a concentration on quantitative methodologies leads to a lack of accuracy. For instance, such methodologies cannot encompass peculiar characteristics of countries and fail to explain how institutions are embedded in different countries. Therefore, an alternative strand of literature argues that the determinants of central bank independence are too historically dynamic, complex, and multifaceted to

[9] This methodology follows Elgie (2002), who analyses the politics of the European Central Bank (ECB) with a principal-agent framework.
[10] For a general review of historical institutionalism, see for instance, Steinmo, Thelen, and Longstreth (1992) or Campbell (1998).

be completely obtained in static quantitative studies. Significant results are better to be expected from detailed country-based research "based on an inductive, historically grounded political economy approach" that is helpful to explain the complexity of multiple causation (Bell 2001: 460).

Japanese politicians, the MOF and the BOJ debated over central bank law revision on two occasions (1957 and 1964) before central bank reform finally took place between 1996 and 1998. This development offers the opportunity to apply a process-tracing analysis about the timing of central bank reform, for the Ministry of Finance (MOF) had resisted all reform attempts before 1996. A process-tracing analysis can be used for each attempt in order to understand why central bank reform was rejected or finally implemented. Process-tracing involves considering the government's motivations towards reform, and perceptions of the respective circumstances,[11] including the relationship between the central bank and the government.

Since the 1990s, an increasing number of scholars have employed qualitative methods based on empirical research to the research field of central banks. This research includes, the Bundesbank (Goodman 1991, 1992; Heisenberg 1999; Kennedy 1991; Marsh 1992), the European Central Bank (Howarth and Loedel 2003; Loedel 1999), the US Federal Reserve (Woolley 1984; Morris 2002), the Bank of England (Elgie and Thompson 1998; King 2005), the Bank of France (Elgie and Thompson 1998), the Bank of Brazil (Taylor 2009), and the Reserve Bank of Australia (Bell 2001, 2002). This dissertation aims to add the Bank of Japan to the list.

The data collection upon which this dissertation is based consists of several sources: the relevant economic and political science literature, central bank documents, minutes of Monetary Policy Board Meetings, official statistics, and a variety of newspaper articles (e.g., *Asahi Shinbun*, *Nihon Keizai Shinbun* [short: *Nikkei*], and *Yomiuri Shinbun*). The data gathered on the Bank of Japan, including complete transcripts[12] of Monetary Policy Meetings (MPM) (*gijiroku*), offers insights into a central bank, more precisely, as how central bank officials view their role under the new institutional framework of a reformed central bank. Additional sources are interviews. Between 2007 and 2009, 23

[11] See, e.g. King (2005) and Yee (1996).
[12] Available only in Japanese language.

expert interviews were conducted with Bank of Japan officials, Ministry of Finance officials, and monetary experts in the academic and business sectors.

3. CENTRAL BANK REFORM IN JAPAN

3.1 Introduction

In the late 1980s and 1990s, "a veritable wave of independence flushed over the world of central banking" (Marcussen 2005: 905) and the term of central bank independence has developed into a "universal catchphrase" (Bernhard 2002: 19). Numerous governments (the delegating authority) all over the world reformed the legislative framework of their central bank institutions with the purpose of insuring independence of the central bank insulating them from direct political control. Japan is no exception and the Bank of Japan was granted independence in 1998.

This chapter analyses the process of Bank of Japan Law reform. After a short introduction about the establishment of the BOJ, it will be investigated in a process-tracing analysis why previous attempts of central bank reform failed and why in 1998 BOJ Law revision was successful. In the subsequent part, the role of main actors will be analysed in detail.

3.2 The Establishment of the BOJ

The Bank of Japan (BOJ) was established in October 1882, and was modelled after the National Bank of Belgium. The most pressing objective of the BOJ foundation was to fight hyper inflation triggered by nonconvertible currencies (inconvertible paper money) issued by the government and private banks. After the establishment of the Bank of Japan, Japan's national banks lost their power to print bank notes. The central bank's mission was to create a national market, and to provide a stable and reliable currency (Yoshino 1977: 398; Cargill 1989: 21; Iwata 1994: 147; Kanegae 1999: 72-74; Nakakita 2001: 48-49).[13]

The Bank of Japan Act (*nippon ginkô jôrei*)[14] of 1882 privileged the government with immense control over the central bank (Iwata 1994: 145; Kanegae 1999: 72-78; Nakakita 2001: 48-49).[15] This should come as no surprise, because the Ministry of Finance "was heavily involved in the creation of the BOJ", and the Bank of Japan was

[13] The government has printed a huge amount of money in order to deal with a vast deficit. This nonconvertible money was not backed by gold, silver or government bonds.
[14] The functions and operations of the BOJ were formulated in "The Regulation of the Bank of Japan".
[15] The control of the Belgian government over the central bank was stronger than in other European countries such as the U.K., France or Austrian-Hungary (Iwata 1994: 145).

set up owing to the initiative of the then Administrative Vice Minister of the MOF, Matsukata Masayoshi.[16] Both of the BOJ's first two Governors (Yoshihara and Tomita) and its first Deputy Governor were former MOF officials. Due to these institutional arrangements and practices, the MOF dominated the central bank, and, from the very beginning on, the BOJ was treated as part of the government system (Yoshino 1977: 399; van Rixtel 2002: 124; Iwata 1994: 145).

3.3 The Bank of Japan Law Revision 1942

Japan's military government reorganised the BOJ in February 1942 under the Bank of Japan Law (*nippon ginkô hô*).[17] The Bank of Japan Law of 1942 was modelled after the German Reichsbank Law of 1939, which imposed unconditional government authority over the central bank. Due to strong government control, the BOJ acted as a subservient to the government. The BOJ's central role was to support the government by financing the war economy through monetizing government debt and an unlimited supply of credit. The Governor of the BOJ enjoyed complete power over the board of directors regarding monetary policy, while the government had responsibility over the appointment of the Governor. The organisational body of the BOJ changed from a stock company (*kabushiki gaisha*) to a special government corporation (*tokushu hôjin*) with the government holding 55 per cent of the outstanding BOJ shares of 100 million Yen[18] (Bebenroth and Vollmer 2007: 46; Bank of Japan 2004: 3; Cargill 1989: 21-24; Iwata 1994: 147-148; Kanegae 1995, 1999: 71-78; Kawakita 1995: 12-14; Madsen 2004; Mikitani and Kuwayama 1998: 1-2; Nakakita 2001: 48-49; Ôshima and Ide 2006; van Rixtel 2002: 124-126).

Before analysing the BOJ reform of 1998, the following chapters will identify why previous attempts of central bank reform failed.

[16] Matsukata acted as Finance Minister from 1885 to 1892 and with several discontinuations from 1896 to 1890. He has visited France and other European countries in February 1878 and studied European finance and monetary systems and policies. Since then Matsukata considered Western central banks as a role model for a Japanese central bank (Iwata 1994: 145-147; Yoshino 1977: 382-383).
[17] Cargill, Hutchison and Itô (2000: 86) argue that the 1882 Law and the wartime law from 1942 exposes only little variations and that the differences were often exaggerated in the literature.
[18] When the BOJ was established the government possessed half of the shares. In 1942 the contingent was increased to 55 per cent (Iwata 1994: 145; 173).

3.4 Political Debates over BOJ Independence – Failures of Bank of Japan Law Reform

3.4.1 Bank of Japan Law Reform during the Occupation Era[19]

After World War II, the Allied Powers tried to alter the Bank of Japan Law towards more democratisation of the monetary policy process. The Supreme Commander of the Allied Powers (SCAP), General Douglas MacArthur, put his focus on the revision of the Bank of Japan Law, aiming to democratise the BOJ. This complex subject was seen as so important that in August 1945 the US War Department already issued guidelines for the 'Control and Use of the Bank of Japan' even before the war has ended. These guidelines included dismissing members of the executive board, proposals for issuing new Yen, and suspending the use of foreign exchange reserves. In response to the US American initiative, the Japanese government set up an own committee for reforming the BOJ in October 1945. The incentive was to keep the SCAP out of the important issue of financial reform.[20] At the same time, Bank of Japan officials took the chance to claim more independency from the government. However, the MOF refused the requests of the BOJ and issued their own concept of a BOJ reform instead. In the end, the reform plans of the Japanese government failed and the Economic Scientific Section (ESS) of the SCAP presented an 'informal memorandum' to the Japanese government.[21] The ESS planned to organize the BOJ, and implement a strong and independent Banking Board, similar to the Board of Governors of the Federal Reserve System (Mabuchi 1995). The Japanese side concentrated all their efforts on resisting the US American suggestions. The MOF, the powerful BOJ Governor Ichimada Hisato, and the Economic Stabilization Agency (ESA; *Keizai antei honbu*) argued that an independent Banking Board would be unnecessary and does not fit the Japanese-style of economic policy. Eventually, the American War Department put an end to the idea of implementing a Banking Board.[22] This means that the MOF and the BOJ successfully collaborated to resist pressure from the U.S.[23] (Holtfrerich and Iwami 1999; Iwata 1994:

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[19] This section is based mainly on Holtfrerich and Iwami (1999).

[20] Certain scholars observed that in comparison to the German government the Japanese government was able to maintain some degree of freedom to resist orders from the SCAP (Holtfrerich and Iwami 1999: 87; Mikitani and Kuwayama 1998: 2).

[21] It should be noted that this 'informal memorandum' has not been authorized by the War Department.

[22] According to Holtfrerich and Iwami (1999: 99), Washington preferred to concentrate its reform plans on the stabilization rather than to reform Japan, as William H. Draper, Undersecretary of the US Army, repeatedly stated. In this way, it was argued that an implementation of a Banking Board conceivable could harm a recovery of the Japanese economy.

[23] Mabuchi (1995) wonders why the BOJ worked against the implementation of a Banking Board since this would have made the BOJ more independent from the MOF.

148; Kawakita 1995: 47-50; Mabuchi 1995; Nakakita 2001: 57; Yamawaki 2002: 72-75).

However, the effort of the US has contributed to one institutional change regarding a new structure of the Bank of Japan. In 1948, the ESS-Finance Division sought to implement a Policy Control Board.[24] One year later, US President Truman sent Joseph M. Dodge, chairman of the Detroit Bank, to Tôkyô in order to serve as MacArthur's financial advisor. Dodge's mission was to help with the stabilization of the Japanese economy. Between March and April 1949, Dodge and BOJ Governor Ichimada met several times to discuss the issue of financial reform, and, this time, the BOJ Governor did not oppose to the implementation of a Policy Board. Ichimada agreed to a compromise plan and accepted the implementation of a Policy Board as the highest authority on monetary policy (Bank of Japan 1986: 295-301; Kanegae 1999: 16; 75-78; Nakakita 2001: 57). Finally, the new Policy Board (*Kinyû seisaku iin kai*) was set up in June 1949 and was composed of seven members: the Governor plus four economists, each with expertise from agriculture, industry, commerce, regional or city banking. In addition, two government representatives from the MOF and the Economic Planning Agency (EPA) joined the Board, but had no voting rights.

Legally, the Policy Board was the supreme decision-making body regarding monetary policy (Miller 1996: 5). However, some measures were implemented to limit the power of the Board in order to make them more suitable for the conditions of the Japanese political economy.[25] In the end, "the operational structure of the BOJ was left unaltered" (Mabuchi 1995) and old mechanisms of interaction between the BOJ and MOF remained intact. Due to its relatively weak influence, the new Policy Board was commonly called 'sleeping board'. SCAP efforts to reform the BOJ failed to weaken the relationship between the Bank and the government (Cargill, Hutchison and Itô 1997: 22-23; Holtfrerich and Iwami 1999: 97-100; Ministry of Finance 1960: 32).

[24] Some SCAP officials worried about the strong influence exerted by the first post-war BOJ Governor Ichimada (1946-1954) and his rather sloppy stance towards inflation. Certain scholars compared his power with the Pope in the Vatican (*rôma no hô ô*) (Kawakita 1995: 49; Yamawaki 2002: 73).
[25] For details, see Mabuchi (1995).

3.4.2 The Discussion of the Bank of Japan Law Revision between 1957-1960 and 1965

Two attempts to revise the Bank of Japan Law occurred in the late 1950s and mid 1960s. In 1960, members of the Financial System Research Council (FSRC; *Kinyû Seido Chôsa Kai*), an advisory panel which answered to the finance minister, called for central bank reform, but the committee failed to reach a conclusion. Five years later in 1965, a second attempt ended with the same result. After Japan became an IMF Article 8 nation in 1964, BOJ Governor Yamagiwa[26] reopened the discussion in a testimony in the Upper House, but the submission of a revised Bank of Japan Law draft to the Diet was postponed (Kanegae 1999: 11-13; Takahashi 1997; Yamawaki 2002: 102-103). In both cases, the reason for the failure of central bank reform was a disagreement about the contents of a new law between the BOJ and the MOF. While the BOJ sought more independence in its financial operations, the MOF wanted to continue its wide-ranging control over the Bank.[27]

After starting investigations about central bank reform in August 1957, the FSRC submitted a paper called "Recommendations Concerning the Bank of Japan and Explanatory Notes" (*nippon ginkô seido ni kan suru tôshin narabi ni setsumei sho*) to the Minister of Finance in September of 1960.[28] The problem was that the FSRC did not reach an agreement about the most urgent subject of whether to change the relationship between the MOF and BOJ. The key question was whether the MOF should be empowered to issue direct orders to the Bank, or whether it just should have the right to postpone BOJ decisions (Kanegae 1999: 3-4; Miller 1996: 10, note 38; Yamawaki 2002: 102-103).

The opinions for and against more central bank independence were split in the FSRC. Consequently, the final draft of the committee consisted of two different opinions. The MOF's view of how to basically maintain the current Bank of Japan Law was referred to as "Plan A", and emphasized the importance of government control over the Bank. The key person of this group was Shimomura Osamu, MOF bureaucrat and former BOJ

[26] It should be noted that BOJ Governor Yamagiwa had his origin at the MOF.
[27] Mikitani and Kuwayama (1998: 2) argue that although central bank reform was debated in a general sense, the focus was never on most fundamental questions, such as how to re-structure the BOJ in order to yield a more independent central bank or a more successful monetary policy.
[28] For details, see Kanegae (1998: 5-6).

Governor, who fiercely opposed all efforts to enhance central bank independence. According to Plan A, the government should have the responsibility to maintain the value of the currency, and the Bank's operations should be closely linked and subordinated to the government's economic policy. Coined differently, the policies of the central bank and the government should be unified under the principles of the government, and the Bank shall be obliged to follow the directives of the Finance Ministry[29] (Iwata 1994: 149-150).

On the contrary, the views of the Bank of Japan, which was represented by BOJ official Matsumoto Shigeo, were formulated in a draft labelled "Plan B". This plan criticized the current Bank of Japan Law from 1942, highlighting that this law, with is similarities to the German Reichsbank Law, is based on the idea of totalitarianism. The BOJ regarded the MOF as too powerful in the subjects of supervision, its control over the budget, and the subordinate position of central bank key staff (Iwata 1994: 149). Furthermore, Plan B pointed out that an independent central bank is important in order to avoid excessive lending to the government, which might have detrimental impacts on price stability. Hence, the power of the government should be limited to the appointment of the Bank's key staff, and the participation in the Policy Board. Too much governmental interference in the decision making of monetary policy was considered harmful to the central bank's goal of price stability. As a consequence, the government's direct influence on monetary policy shall be restricted to suspension at most and not to overruling decisions of the Policy Board (Cargill 1989: 30; Cargill, Hutchison and Itô 1997: 23-24; 2000: 89; Kanegae 1995: 138-139; 1999: 3-15; Langdon 1961; Ministry of Finance 1960: 53-56, 108-117, 205).

In the end, the FSRC could not solve the conflict between "Plan A" and "Plan B", and, consequently, the Bank of Japan Law remained unchanged (Kanegae 1995: 154-155; 1999: 9-11; Yamawaki 2002: 102-103).[30] Dwyer (2004: 248) argues that the strong alliance between the MOF and the LDP hindered a revision of the Bank of Japan Law:

[29] The relevant articles regarding the Finance Ministry are Article 43 and 44 of the Bank of Japan Law.
[30] However, in the late 1960s the Finance Vice Minister Ishino Shinichi and BOJ Deputy Governor Sasaki Tadashi agreed to a compromise plan. Instead of a legislative revision of the Bank of Japan Law a "reasonable cooperation" between the Ministry of Finance and the BOJ was decided (Suzuki 1996).

> "Although efforts to revise the law in the late 1950s and early 1960s did not bear fruit, they illustrate the BOJ's longstanding interest in greater independence, the MOF's longstanding opposition to it, and the former power of the alliance between the MOF and Japan's long-ruling Liberal Democratic Party (LDP) to prevent even reforms supported by the central bank and the major big business and banking associations."

It is remarkable that the Bank of Law from 1942, with its out-dated wartime implications and with its "structural weakness" (Grimes 2001: 204), withstood all reform movements, and remained the legal framework for the Bank of Japan for over 55 years. It was not until 1996 that a turning point in central bank reform movement in Japan was reached. It will be the subject of the following chapter.

3.5 The Bank of Japan Law Reform between 1996 and 1998

3.5.1 Analysis of the Process of the Central Bank Reform 1996

The previous section demonstrated why all former attempts to revise the Bank of Japan Law failed. After these failures, there was "little interest" (Cargill 1989: 30) to continue with the attempt to alter the institutional set up of the BOJ, i.e. that the Bank's status as MOF subservient continued until the mid 1990s. The defeat of failed reform in 1960 was regarded as a "trauma" in the BOJ (Mabuchi 1997: 149). As a result, from that time on, the BOJ remained in a "stance of passivity" towards reform movements,[31] and the subjects of 'central bank reform' and 'independence' were considered as a "taboo" in BOJ circles (Kanegae 1999: 17). Most central bankers accepted the subordinated condition, and preferred to stay in this comfortable arrangement "embraced" by the Ministry's protection from political intervention (Nakakita 2001: 67-68; Ogata 1998: 27-28). Similarly, MOF officials enjoyed the benefit of control over the bank under the BJL from 1942. Due to this sticky situation, central bank reform has only been discussed in academic circles and among retired BOJ staff.[32]

It was not until 1996 that the complex issue of central bank reform became a subject of discussion again. The Hashimoto[33] government, a tripartite ruling coalition consisting of the Liberal Democratic Party (*Jiyû Minshutô*; LDP), the Social Democratic Party (*Shakai Minshutô*; SDP), and the New Party Sakigake (*Shintô Sakigake*, from here on Sakigake), set financial system reform on the Cabinet's political agenda with the

[31] "*shôkyoku shisei*" (Asahi, 12 May 1996).
[32] Interview, December 2009.
[33] Abe (1996) reports that Hashimoto already in 1989 during his position as Finance Minister argued that the BOJ lacks independence in comparison to other main central banks.

revision of the Bank of Japan Law as "most significant check on the ministry's power" (Grimes 2001: 204).

3.5.2 The Ruling Coalition's Project Team for Financial Reform

On 6 February 1996, negotiations about how to reform the Ministry of Finance started and Katô Kôichi, Secretary General of the LDP (*kanjichô*), took the initiative to call for MOF reforms.[34] A number of influential lawmakers, including Hatoyama Yukio, the representative Secretary General (*daihyô kanji*) of the Sakigake, demanded a project team be set up under the ruling coalition to work out a reform plan for the Finance Ministry. On 16 February, the governing coalition established a six-member committee for the MOF reform (*ôkurashô kaikaku mondai iin kai*). It was chaired by Katô. This committee founded a sub-committee, the Project Team on the reform of the MOF, which was headed by Itô Shigeru, the Head of Policy Research of the SDP (*seisaku shingi kaichô*). The Project Team consisted of 21 Diet members: ten from the LDP, seven from SDP, and four from Sakigake.[35] Yamasaki Taku (LDP) and Tokai Kisaburo (Sakigake) acted as co-chairmen. In March 1996, the Project Team had discussed the subject of central bank reform first and foremost, making it a "high-profile policy issue"[36] (Cargill, Hutchison and Itô 2000: 91; Mabuchi 1997: 134-136; 144; 150-151; Kanegae 1999: 20-23; Toya 2006: 162-165; Yamawaki 2002: 98-100).

3.5.3 The Intention Behind Central Bank Reform in Japan

This section attempts to answer the question why the Project Team raised the issue of Bank of Japan Law reform in 1996, and declared it the most urgent subject of administrative reform. Here, it is crucial to note that central bank reform in Japan cannot be regarded as a single reform. Rather, it was accompanied by larger financial

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[34] Katô suggested shifting the BOJ and the section of MOF overseeing financial administration to Ôsaka. The media misinterpreted these comments for a plea to divide the MOF. The Ministry's top officials asked for a clarification of Katô's statements, but Katô deliberately decided not to take back his misinterpreted remarks (Tahara 1998, in Toya 2006: 162).

[35] LDP members: Yamazaki Taku, Yosano Kaoru, Mizuno Kiyoshi, Satô Shinji, Yanagisawa Hakuo, Machimura Nobutaka, Kaneko Kazuyoshi, Saitô Fumio, Sekine Noriyuki, Shiozaki Yasuhisa.
SDP members: Itô Shigeru, Nagai Tetsuo, Hayakawa Masaru, Hosoya Harumichi, Yamamoto Tsutomu, Itô Mototaka, Kajiwara Keigi.
Sakigake members: Tokai Kisaburô, Ozawa Sakihito, Igarashi Fumihiko, Tanaka Kô.

[36] According to Cargill, Hutchison and Itô (1997: 193), Prime Minister Hashimoto considered central bank reform was the most important goal in the Cabinet's agenda.

administrative reform. More precisely, the revision of the Bank of Japan Law was part of MOF reform (Nakakita 2001: 50-51).[37]

At the first meeting of the Project Team on 27 February 1996, a prominent guest speaker Tachi, the chair of the FSRC[38], gave a speech. After this speech, discussions about central bank independence started (Dwyer 2004: 255, footnote 17). In the following month, the Project Team decided that the revision of the Bank of Japan Law should be made a top priority in order to make the BOJ independent from the MOF (Hori 2005: 122; Mabuchi 1997: 136-151). Itô Shigeru, the Chair of the Project Team, argued that the Bank of Japan Law must be revised due to its outdated war-time character (Kanegae 1999: 20-21). Itô's decision to examine the independence of the BOJ as the first and most important step of financial reform was widely seen as turning-point in the process. After visiting the BOJ in April 1996, one member of the Project Team expressed the view that "[t]he reform of the Ministry of Finance and the revision of the Bank of Japan Law which we are now seriously discussing are two sides of the same coin. […] We want to promote it as a determination of the ruling parties. The Bank of Japan should also cope with it positively." (Nakakita 2001: 64). There was still fierce opposition from politicians, such as Yanagisawa that had to be overcome. In order to realize central bank reform, Itô and Shiozaki, fierce proponents of central bank independence, needed to gain a majority in the Project Team.

According to Kanegae (1999: 20-21), there was still room for interpretation concerning Itô's decision to make the independence of the BOJ a priority in the Project Team. There are two alternative explanations for this decision. The first one presumes that influential MOF officials requested Itô to discuss central bank reform in the first place, so as to satisfy the public and the media and to avoid heavier attacks on the MOF. Put it differently, the most important purpose was to grant the BOJ independency to dispel the attention from the Ministry (*mondai no surikae*). MOF officials sought to avoid a more fundamental reform or a total break-up of the Ministry, even at the cost of losing control over monetary policy. The second hypothesis supposes that central bank reform was an issue that the still powerful MOF could not refuse, because of the outdated character of the old, war-time Bank of Japan Law of 1942. Altering the central bank law was

[37] See, Kawakita (2000), Mabuchi (1997) or Toya (2006) for a detailed analysis of MOF reform.
[38] See, following section.

regarded as a relatively easy task which would lead to avoiding strong interference by the MOF and would decrease the risk of failure.

The first explanation considers the MOF as a major player in achieving an independent BOJ. Cargill, Hutchison and Itô (2000: 93-94) identify the agreement of the MOF as an important factor of central bank reform, although its concurrence was "not enthusiastic". One can argue that the MOF's partial agreement to a reform can be explained by the fact that organisational survival is the ultimate goal in comparison to other goals, e.g., the maximization of organisational power (Toya 2006: 11). In other words, a conceivable strategy for MOF bureaucrats was to trick the public into believing that the MOF was supporting reform movements when, in fact, they were just trying to preserve as much power as possible. One key person was Tachi, chair of the FSRC. With respect to Tachi's affiliation to the Ministry, one member of the Project Team "suggested that MOF officials may have asked him to plant the idea of central bank reform as an offering to make a small cut to avoid a deeper one"[39] (Dwyer 2004: 255).

The second explanation indicates that lawmakers believed that the MOF would face difficulties to oppose central bank reform given the recent economic developments. That is, politicians regarded BOJ Law revision as an easy way to please the electorate without risking fiery disputes over MOF reform (Nakakita 2001). This hypothesis views the MOF as a passive player. In comparison to BOJ Law revision, a comprehensive reform of the MOF was regarded as a task that was too challenging and difficult to complete. Therefore, it can be argued that politicians choose to revise the Bank of Japan Law in order to have a promising start and to present some quick results of reform as a strategy to deflect public criticism against the ruling coalition (Asahi, 12 May 1996). As a result, Kuroda Akio (1996), former BOJ official and Professor at Meiji University, argues that politicians were driven by "impure motives" (*dôki fujun*) to reform the MOF on the back of the BOJ.

Mabuchi (1997: 144-146) confirms this view, and finds that the MOF's internal committee was convinced that central bank law revision is less harmful than a

[39] An additional indicator in support of this argument is the assumption that an internal committee of the MOF concluded that central bank reform would cause less harm than a decrement of fiscal and financial responsibilities (Dwyer 2004: 255).

comprehensive cut in its fiscal and financial authority. Besides, opposition against Bank of Japan Law revision was particularly difficult. However, similar to the first explanation, MOF officials only agreed to reform, because they sought to prevent further damage to the MOF. Still, after agreeing to central bank reform, MOF officials tried to influence the outcome of the Bank of Japan Law revision in their favour as much as possible. Although this strategy is different than the first one, it also fits the goal of organisational survival by the Ministry. Kanegae (1999: 21) argues that although this hypothesis does not fully explain central bank reform in Japan, it is a logical approach as Bank of Japan Law reform was connected with the task of reform of the Ministry of Finance, as sources of the Project Team demonstrate.[40]

Both explanations have reasonable arguments. Since they do not contradict each other and both cannot be falsified, an arrangement of both concepts is a conceivable conclusion, and it is possible to combine both explanations into one single, consistent hypothesis. (Dwyer 2004: 255) divides the actors into two groups, in supporters and opponents of central bank reform. Those who supported MOF reform considered Bank of Japan Law revision as a first move towards MOF reform, a move that could not be contested by opponents (hypothesis one). In contrast, opponents of radical MOF reform believed that BOJ reform would satisfy the supporter's side and protect the Ministry against fundamental reform (hypothesis two).

Based on these explanations, Ogata (1998) argues that Bank of Japan Law revision was just a form of camouflage used to avoid more urgent subjects of Japan's financial system. With politicians concentrated on BOJ reform, MOF officials believed to be able to avoid more important issues of institutional reform which would have cut the Ministry's power to a higher extent. The goal of lawmakers was to demonstrate an active, reform supportive stance in order to appease the public.

[40] "The organisation of a new monetary administration and monetary policy" (*atarashii kinyû gyôsei, kinyû seisaku no kôchiku ni mukete*), 1996, 13 June and "Report about MOF reform" (*ôkurashô kaikaku ni tsuite hôkoku*), 1996, 25 September (Kanegae 1999: 21).

3.5.4 The Project Team: "The Construction of New Financial Administration and Policies

On 13 June 1996, the Project Team presented a basic document named "The Construction of New Financial Administration and Policies" (*Atarashii kinyû gyôsei, kinyû seisaku no kôchiku*). It includes a recommendation for a revision of the Bank of Japan Law, aiming to strengthen the Bank's independence from the MOF (Hori 2005: 121-126; Kanegae 1999; Mabuchi 1997: 186; Yamawaki 2002: 101). In more detail, the Project Team regarded the following aspects as a basis for further discussions of central bank reform:

1) To investigate Bank of Japan Law fundamentally to reform the Law
2) To strengthen the independence of the BOJ
3) To strengthen the transparency and accountability of the BOJ
4) The investigation of the functions of the Policy Board of the BOJ
5) The reorganisation of the relationship between the BOJ and government

After the submission of the Project Team's document, further examination of the revision of the central bank law was conducted by the "Central Bank Study Group" (CBSG; *Chûô ginkô kenkyû kai*), the Prime Minister's private advisory council (*shiteki shimon kikan*).

3.5.5 The Central Bank Study Group ("Torii Committee")

In July 1996, Prime Minister Hashimoto arranged a private advisory council[41] to investigate Bank of Japan Law revision on the basis of the projects team's recommendations and to improve the central bank's independency and the transparency of its policymaking. The so-called "Central Bank Study Group", chaired by Torii Yasuhiko, an economist and president of the Keio University, contained financial and legal experts, six academics and two business people. The eight members, apart from Chairman Torii, included Kanda Hideki, Professor of Law at the University of Tôkyô, Satô Kôji, a constitutional law scholar at Kyôto University, Suda Miyako, Professor of

[41] Ôya (1996: 15) argues critical against advisory councils in Japan: "The government's system of advisory councils, a key element of the so-called Japanese system, has been described as a cloak of invisibility in which bureaucrats wrap themselves and as a shield politicians use to ward off responsibility". [sic] In practice, it seems that political leaders choose councils in order to confirm their decisions and to enforce their desired policies, creating an impression of responsibility.

international finance at Gakushûin University, Tachi Ryûichirô, Professor Emeritus at the University of Tôkyô and Chairman of the Financial System Research Council, Imai Takashi, Vice-Chairman of the Keidanren, Fukugawa Shinji, President of the Dentsû Communication Institute Inc., and the chair's assistant and special expert member Yoshino Naoyuki, Professor of Finance at Keio University (Kanegae 1999: 192; Miller 1996: 15, footnote 59).

In accordance with Yamawaki (2002: 109-110) and Mabuchi (1997: 259), both the BOJ and MOF tried to push their favourite candidates into the CBSG. Prime Minister Hashimoto selected Torii Yasuhiko[42] as chairman, while the rest of the CBSG members were equally divided between candidates of the BOJ and the MOF. Among BOJ candidates Satô, Fukugawa and Imai were chosen, whereas Nakagawa Kôji was rejected. Candidates of the MOF included Tachi, Kanda and Suda. Yoshino was accepted by both parties.

The discussions on central bank reform started on 31 July 1996, and the group met ten times over a period of four months in the office of the Prime Minister.[43] [44] There was a fierce discussion, mainly between Satô and Fukugawa, about Article 65 of the constitution. Satô argued that providing the BOJ with the power to decide over its own budget would be against the constitution, a point that Fukugawa fiercely opposed (Yamawaki 2002: 110-115). On 17 October, three days before the Lower House parliamentary elections, the council published a preliminary report calling for more central bank independence (The Central Bank Study Group 1996; Dwyer 2004: 256; Pascha 2005a: 9).

On 12 November, the group submitted their final report titled "Reform of the Central Bank System – In Pursuit of Open Independence"[45] to Prime Minister Hashimoto. The key points of this report were claims of independence of the central bank in the operation of financial transactions, enhanced accountability and transparency (Kanegae

[42] It has to be noted that Torii was no monetary expert, but he was close to Prime Minister Hashimoto (Mabuchi 1997: 260).
[43] Governor Matsushita attended the first meeting of the study group as a witness presenting his views. He encouraged the panel to discuss BOJ's independency and revise the Bank of Japan Law (The Japan Times 1 August 1996).
[44] Mabuchi (1997: 261-284) and Kanegae (1999: 23-34) provide insightful details of all meetings.
[45] In Japanese: *Chûô ginkô seido no kaikaku – hirakareta dokuritsusei wo motomete*.

1999; Lukauskas and Shimabukuro 2006: 132; Malcolm 2001: 349; Mikitani and Kuwayama 1998: 2-3). The MOF opposed the draft of the CBSG, because it did not include government representatives in the Policy Board (Volz and Fujimura 2008: 6).

3.5.6 The Report of the Central Bank Study Group: *Reform of the Central Bank System – In Pursuit of Open Independence*

This final report presented the group's ideas on "the basic principles on which the central bank should be based" and considered securing central bank independence as most important subject (The Central Bank Study Group 1996: 5). Furthermore, it stated that the Policy Board should be strengthened and should have the final decision in the area of monetary policy (The Central Bank Study Group 1996: 5-10). In contrast, the necessity of policy coordination[46] of the BOJ and the government was emphasized: "there is a growing need to maintain a close cooperative relationship between the government and the Bank" (The Central Bank Study Group 1996: 10). Furthermore, the report claims government control over the bank, including the right of the government to postpone a decision of the Policy Board and the government's authority to give orders to the Bank in emergency (The Central Bank Study Group 1996: 11-14). The report was build of seven points:

1. Introduction: This part stresses the fact that the Law from 1942 was outdated and needed to be revised. Furthermore, enhanced independence is an indispensable prerequisite for the conduct of monetary policy.
2. Objectives: The report underlines two objections of the Bank of Japan: First, the primary goal is price stability and second, the maintenance of financial system with a functioning credit and payment system.
3. Open independence: The role of the Policy Board as major decision-making body should be stressed. The Policy Board members should be appointed by the government. The government's power to give directives to the Bank should be abolished.
4. Transparency and accountability: This section consisted of measures how to enhance the BOJ's transparency and accountability, i.e. the publication of the

[46] The point of coordinated policy was criticised by several sources, for instance from the private "Study Group on the Independency of the Central Bank" chaired by Professor Mikitani from Kobe University (Mikitani 1997).

minutes of Policy Board meetings, methods to explain monetary policy decisions before the Diet.

5. Strengthening the Policy Board: The ultimate authority of the Policy Board needs to be restored. The Policy Board must take the responsibility for monetary policy and its business operations. Policy Board members should be composed of BOJ's executives, the Governor and outside experts, but BOJ executives should not form a majority in the Board. The government should be able to sent representatives, but these should not have voting rights.
6. BOJ and the relationship with the government: The recommended relationship with the government has three features. In regards of monetary policy, the Bank should act independently; financial stability should be guaranteed with the cooperation of the government, whereas the issue of foreign exchange intervention should be managed by the government alone. In case of different opinion between the BOJ and the government, the government should be equipped with the right to request a postponement of monetary policy decisions.
7. BOJ business operations: The BOJ acts as the bank for the banks and as "fiscal agent for the government as bank of government". The Bank should maintain an orderly credit system through on-site examinations of financial institutions. However, to secure the stability of financial markets and institutions the government has the "ultimate responsibility". The Bank acts as lender of the last resort, "either under the direction of the government or on its own initiative".

3.5.7 The Report to the Minister of Finance and the Promulgation of the New Bank of Japan Law

After the Prime Minister Hashimoto received the CBSG report, he requested the Finance Ministry to investigate the revision of the BOJ further.[47] On 19 November, the Financial System Research Council (FSRC; *Kinyû seido chôsakai*), an advisory body of the Minister of Finance (*Ôkura daijin no shimon kikan*), was charged with the task of central bank revision based on the recommendations made by the Central Bank Study Group. In a general meeting, the FSRC decided to launch a subcommittee on the Revision of the Bank of Japan Law (*Nippon ginkô hô kaisei an ni kan suru shôiin kai*).[48]

[47] I thank Professor Dr. Kanegae Tsuyoshi for discussing the issue via email in 2012.
[48] The members were Tachi Ryûichirô, Kaitsuka Keimei (Chûô University, Public Finance), Egashira Kenjirô (Tôkyô University, Business law), Nakanishi Masahiko (Vice Chairman of the Tôkyô Chamber

Both committees were chaired by Tachi Ryûichirô (Bank of Japan 2004: 216; Miller 1996: 15; Cargill, Hutchison and Itô 1997; Kanegae 1995, 1999; Mikitani and Kuwayama 1998: 2-3; Mabuchi 1997: 296-298).

This subcommittee met ten times throughout a period of approximately two and a half months.[49] The subcommittee presented a draft report to the FSRC on 4 February 1997 and two days later FSRC Chair Tachi presented the final report "Report on the revision of the Bank of Japan Law" (*Nippon ginkô hô no kaisei ni kan suru tôshin*) to Nishida Yoshihiro, parliamentary vice finance minister. The subcommittee supported the idea of reinforcing central bank independence, for the report concluded "[T]he current Bank of Japan Law, enacted in 1942, needs fundamental review, because it contains many provisions which are no longer consistent with today's economy and finance […] for the Bank of Japan to gain credibility from the public sector and financial markets, it is indispensable to reform the entire policy making framework with emphasis on securing central bank independence […]". Somewhat ironic seems the passage "we strongly hope that the Bank of Japan actively reforms itself, aiming at becoming a central bank suitable to be the nucleus of…Japan's financial system in the 21st century" as the BOJ cannot mandate independence to itself (cited from Miller 1996: 16). In general, the committee argued for a continuing, but diminished role of the MOF. The report aimed to maintain the Ministry's power to issue orders to the Bank and the right to be informed about the Bank's activities (Miller 1996: 16-19). Cargill, Hutchison and Itô (2000: 96) state that the report "closely followed the November 1996 report" of the Project Team.

On 11 March the FSRC report was finally accepted by the Cabinet and submitted to the Diet.[50] The Diet passed the new Bank of Japan Law on 11 June 1997, and on 1 April 1998, the Bank of Japan Law came into effect (Bank of Japan 2004: 216).

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of Commerce and Industry), Nishizaki Tetsurô (International management consultant), and Fujiwara Sakuya (Jiji Press journalist). In addition, the committee included following observing members: Okada Akishige (Japan Federation of Bankers Association), Kanda Hideki (Professor of law at the University of Tôkyô), Sakata Masahiro (Cabinet Legislation Bureau and former MOF official), Mitani Takahiro (BOJ official), and Yoshino Naoyuki (Professor of finance at Keio University).

[49] Mabuchi (1997: 299-334) provides insightful details of all ten meetings.

[50] Grimes (2001: 205-206) adds an interesting narrative. On 20 February 1997, the ruling coalition rejected the draft of the FSRC and submitted on 11 March a new version with the removal of the Cabinet's right to postpone policies. This draft was accepted by the Lower House on 22 May and the Upper House on 11 June.

3.5.8 Critique of the Reform Process

Many observers criticised the process of the revision of the Bank of Japan Law. A major point of criticism focussed on the fact that central bank reform was conducted in committees by the very same people. Indeed, it is evident that some people were a member of more than one research council. This is particularly irritating in the case of Tachi, who as the chair of the FSRC was also a member of the CBSG.[51] In addition, the selection of the members of the FSRC seems dubious. Mabuchi (1997: 61) criticised that in most cases the members were chosen on the premise not to harm the MOF any further. Some members have been members of other councils of the MOF, i.e. they were possibly biased in favour of the MOF. The observing members in the FSRC subcommittee were representatives from another government agency, the Cabinet Legislation Bureau (CLB; *Naikaku Hôsei Kyoku*), but originally came from the MOF. These facts led to the conclusion that the central bank reform was conducted under the leadership of the MOF (Nakakita 2001: 73-74).

Critique also came from important actors of the BOJ reform process. On 22 January 1997, the chair of the ruling coalition's Project Team Itô stated that the discussion in the FSRC contradicted the intention of the three party coalition towards enhanced central bank independence and that there had been a dramatic change in the reform process. With respect to Itô's modest character, this statement was harsh criticism (Mabuchi 1997: 313-314). Similarly, Fujiwara, member of the FSRC study group and BOJ Deputy Governor from 1998 to 2003, criticised the intense pressure exerted by the MOF in the FSRC in regards of the revision of the BOJ Law (*ôkurashô no kaiaku atsuryoku*) (Fujii 2004: 30). Amyx (2000: 6-7), citing a close observer of the reform process, notes that the FRSC is "convened, sponsored, and guided by officials of the [MOF]. As a result, it generally functions as a mechanism for legitimising proposals from the ministry itself."

In sum, it can be argued that "much of the drafting was conducted in the private councils of the ruling LDP under the intellectual leadership of Ministry of Finance staff" which negatively influenced the outcome of the new Bank of Japan Law (see, Chapter 5). BOJ representatives and outside experts in central banking have almost been

[51] It should be noted that Tachi was in the past for a short time at the BOJ. However, his longer experience and influences came from the MOF.

excluded from the reform process. In other words, ideas from professionals with the most expertise have not been taken into consideration (Mabuchi 1997: 60-61; Mikitani 1997; Mikitani and Kuwayama 1998: 3).[52] Saitô (1997: 27) remarks that "the fact that MOF is orchestrating the reform must seem puzzling – if not entirely misguided. […] The fact is that MOF simply does not want anybody else to take a hand in any of the design work for the twenty-first century's financial system". As a result, BOJ officials harshly criticised the new Bank of Japan Law. One central bank official said during the reform process: "If this is the result of the revision, the law should rather be left like it is" (Mabuchi 1997: 60; 309).

Mikitani (1996) criticises the draft of the CBSG, especially emphasizing that not enough academics had been involved in the formulation of the draft. He recommends more neutral discussions which should include academics. Regarding the contents, his criticism can be summarized in nine points:

1. Instead of "*bukka antei*" (price stability), "*tsûka kachi no antei*" (currency stability)[53] should be written
2. More power for the legislative in the appointment process
3. There should be no government representatives in the Policy Board
4. Foreign exchange interventions should be under authority of the BOJ
5. No right of postponement of monetary policy decisions for government representatives
6. No purchase of financing bills by the BOJ
7. The BOJ should decide over its own budget
8. Supervisory right of BOJ through the government should be abolished
9. The reappointment of Policy Board members should be avoided

Similarly, Mikitani (1997) criticises the draft of the FSRC. Some points are a repetition from his critique made in 1996. Mikitani was disappointed that the MOF had not released enough information about the process of the draft. In addition, he underlines the lack of clear opinions by BOJ officials, the involvement of academics and public

[52] Grimes (2001: 206-207) argues similar, namely that public discussion excluded the financial world and was dominated by reform-orientated politicians, the media and the MOF.
[53] I thank Professor Dr. Kanegae Tsuyoshi for useful comments regarding the correct application of the Japanese terms.

discussions. Mikitani distinguishes his critique in three parts: I) Maintenance of central bank independence, II) Goals of the Bank of Japan, and III) Accountability:

I) Maintenance of central bank independence

1. The term "*dokuritsu sei*" (independence) is preferable to the term "*jishusei no sonchô*" (value on autonomy)
2. The relationship between the government and the BOJ is not sufficiently clear to secure central bank independence
3. The right of government representatives to attend Monetary Policy Meetings should be abolished
4. The right to submit a request and the right of postponement of government representatives should be abolished
5. The BOJ's budget should be decided by the Policy Board
6. The supervisory right by the Finance Minister of the BOJ should be limited

II) Goals of the Bank of Japan

7. The goal of the maintenance of orderly financial system should be avoided
8. The power over foreign exchange interventions should be under the rule of the BOJ

III) Accountability

9. The accountability of the BOJ should be strengthened
10. The BOJ should report to the Diet on a direct channel and not through the Finance Minister

3.6 Actors of Central Bank Reform

3.6.1 The Bank of Japan

There are different views with respect to the question of what role the BOJ played in the reform process of its own organisation. Many academic and media sources noted that the Bank of Japan was rather silent, considering BOJ officials as passive pawns trying to avoid statements that can be interpreted as active promotion of central bank independence (Nakakita 2001: 58-59; 66-69; Grimes 2001: 206; Yamawaki 2002: 103; 251). Lukauskas and Shimabukuro (2006: 132) argue that the BOJ did not fight for reform in public, "because it feared retribution by the MOF if it fails to gain independence". Although some officials within the BOJ were willing to fight for more independence (*shusenron*), this effort weakened during the reform process. For example,

the team surrounding Mitani Takahiro, who was an observing member in the FSRC subcommittee, could have pressured for more independence. However, as the only BOJ-affiliated member in the group, Mitani's chances to fight against the MOF's dominance appeared to be hopeless from the very beginning. Altogether, the BOJ's standpoint was a "poor fight" (*kurushii tatakai*), ending in a "declaration of defeat" (*haiboku sengen*) after the end of discussions (Mabuchi 1997: 298; Yamawaki 2002: 125-136).

There are three reasons for the passivity of the BOJ. First, BOJ officials usually had little experience of dealing with politicians.[54] Some BOJ officials even feared the termination of the cooperation with the MOF, because they regarded the relationship as cosy and advantageous for the BOJ. Second, the outcome of the reform was rather ambiguous as the ruling coalition consisting of three parties was not united in their positions; in particular the Socialists were regarded a great uncertainty (Mabuchi 1997: 146-150). Third, the passiveness of the BOJ can be seen as a rational strategy, because previous attempts to revise the Bank of Japan Law, in which the BOJ fiercely fought for more independence, were unsuccessful (Mabuchi 1997: 62-63). The BOJ's position can be interpreted as a "sit-and-wait" strategy, or the attempt to influence the outcome of reform quietly behind the scenes.[55] Indeed, some scholars argue that the Bank was involved in secret discussions with the MOF[56] (Cargill, Hutchison and Itô 1997: 96), and find that BOJ officials made "essential contributions" to the new law (Mikitani and Kuwayama 1998: 3).

Before the Bank of Japan Law was revised, some statements about central bank independence were expressed by the BOJ, in particular by Mieno Yasushi, BOJ Governor from 1989 to 1994. As early as 1994, Mieno expressed concerns regarding the 1942 Bank of Japan Law, arguing that the old law was inappropriate for current times (Kawakita 1995: 72). Considering the concept of central bank independence as a reflection of "human wisdom", Mieno already encouraged a public discussion of central bank independence in 1994. Criticizing the government's wide-ranging authority over

[54] Kawakita (1995: 67) uses the term "*seiji onchi*" to stress the BOJ's inability to deal with politicians.
[55] One former Bank of Japan official stated that the political scientist Mabuchi Masaru was engaged to study and analyse the Bank of Japan Law (Interview, 10 August 2009).
[56] One Bank of Japan official argued that there was "close contact" between the MOF and the BOJ during the reform process (Interview, 25.August 2008).

the Bank under the BOJ Law of 1942, Mieno correctly predicted that "a suitable time for scrutiny [of the Bank of Japan Law] will come" soon (Mieno 1994, 1995).

Governor Matsushita

Without doubt, the key actor of a central bank is the Governor. Thus, an interesting question is how the BOJ Governor Matsushita Yasuo acted. Generally speaking, Matsushita was reluctant to demand enhanced central bank independence. However, at some occasions Matsushita stressed the need for a more independent central bank. For instance, on 5 April 1996, the Project Team on administrative reform visited the Bank of Japan's head office in *Nihonbashi* and held a meeting with Governor Matsushita, Deputy Governor Fukui, and other BOJ executives. The visit of influential Diet members to the BOJ was an unprecedented case. In a subsequent press conference, Matsushita called the first time for more BOJ independence in a direct way. Before that Matsushita only mentioned the necessity of central bank reform in a context with the internationalisation of financial issues (Yomiuri, 6 April 1996). A second example was a press conference in December 1996 in which Matsushita surprised the audience with the claim of central bank independence (Nikkei, 19 December 1996; Nakakita 2001: 64; Yamawaki 2002: 101).

However, such kinds of statements for enhanced central bank independence were very unusual coming from Governor Matsushita, who usually maintained a cautious stance. For instance, Matsushita expressed the view that "[t]he Bank of Japan Law is an old law, but we operate it wisely in consultation with the Ministry of Finance. So revision is a huge task" (Nakakita 2001: 64). As a result, most observers considered Governor Matsushita's statements for more central bank independence in the media in 1996 and 1997 as no more than "facade" (*tatemae*).[57] It should be noted that Governor Matsushita was a former Vice Finance Minister (a so-called BOJ bureaucrat [*nichigin kanryô*])[58] and, arguably, he did not want to impede harm to his "old place" (*furusu*), the MOF (Kawakita 1995: 84). This helps to explain why Matsushita was not overly enthusiastic about an independent central bank. Bank of Japan officials stated about Matsushita that

[57] See, Matsushita (1997): A New Framework of Monetary Policy under the New Bank of Japan Law. Speech to the Yomiuri International Economic Society in Tokyo on 27 June 1997.
[58] For details, see Tsurumi (1982).

the Governor was a MOF bureaucrat until the end (Yamawaki 2002: 101).[59] [60] In drastic words, it can be argued that Matsushita was just a "puppet" for central bank reform.[61] Grimes (2001: 206) notes that a secret BOJ study group, which was instructed to encourage the work of the coalition's Project Team concerning central bank reform, purposely excluded MOF-affiliated Governor Matsushita. This is a definite indicator that Matsushita was not considered to belong to the inner circle of the BOJ. It is rather the case that discussions about central bank independence and reform were inspired by former Governor Mieno, Fukui Toshihiko and Yamaguchi Yutaka (Mabuchi 1997: 150).

In sum, although the vast majority of BOJ officials have welcomed central bank reform, they were passive and did not fight much for central bank independence in public. Rather, they preferred to remain spectators of the institutional change, leaving the initiative and responsibility to other actors, in particular political actors.

3.6.2 State Actors (1) – Bureaucratic Agencies – The Ministry of Finance

The MOF is a very powerful organisation and withstood all central bank reform initiatives until 1996. For instance, efforts by Finance Minister Takemura since 1994 to cut the Ministry's influence were blocked successfully. As a result, at the beginning of the Bank of Japan Law reform process, the MOF was in strong opposition against central bank reform and confident that a revision of the Bank of Japan Law could be avoided.

After facing growing pressure, the Ministry of Finance established an internal project team under the leadership of Administrative Vice Finance Minister Ogawa Tadashi to examine the subject of reform in April 1996. Their explicit task was to limit the extent of change to the MOF as much as possible (Mabuchi 1997: 161-162; Nakakita 2001: 65-67). It should come as no surprise that the foundation of a MOF project team was sharply criticised by politicians from the ruling coalition. For instance, Tanaka Shûsei from the Sakigake party stated that "self-reform would be unable to win public support" (Japan Times April 6, 1996). Fujii Yoshihiro, a Nikkei economic journalist, called the

[59] Personal interview, 8 December 2009.
[60] However, the conclusion that all BOJ Governors with a MOF origin necessarily acted merely in favour of the Ministry is misleading. For instance, Morinaga Teiichirô, BOJ Governor from 1974 to 1979, is an often-cited example, who was regularly praised for his independent behaviour, regardless of his position as a former Vice Minister of Finance.
[61] Interview with former Bank of Japan official, 8 August 2008.

Ministry's move to establish a committee to investigate the reform of its own institution "ironic" (*hiniku*) (Nikkei, 7 April 1996).

The MOF held the view that the Bank of Japan Law from 1949 was not an obstacle for the operations of the BOJ (Kawakita 1995: 72-73). Vice Finance Minister Ogawa has repeatedly argued that the Ministry does not influence the Bank's monetary policy. Thus, he stated that there is no "pressing need" to revise the Bank of Japan Law and that there is "no trouble with the current Bank of Japan Law"[62] (Nikkei, 9 April 1996; Yomiuri, 9 April 1996; JT, 9 April 1996 and 23 May 1996). Ogawa justified these statements with the assumption that "effective policy requires united fiscal and monetary policy."[63] In addition to Ogawa's blunt announcements, MOF officials intensely lobbied lawmakers, preferably influential politicians in the LDP in order to forestall, or at least, to weaken reform. In the beginning, the MOF's fierce lobbying had some success, and several LDP Diet members supported the MOF in its struggle to limit the degree of modifications to the ministry[64] (Brown 1999: 174-190; Dwyer 2004: 256; Lukauskas and Shimabukuro 2006: 132-133; Toya 2006: 162-165).

The MOF's determined efforts to stop reform have led to a temporary break of reform movements. MOF lobbyism continued and bureaucrats, such as the above mentioned Ogawa have tried to influence the reform process by approaching to politicians with the excuse of talking about the *jûsen* problem (housing loan finance companies)[65], deflecting attention from broader problems. In fact, MOF officials were lobbying politicians to their favour, warning them that "enhancing the BOJ's independence is dangerous". It needed intense intervention by influential politicians, particularly by Katô and Yamasaki, to convince party members that MOF reform and an independent central bank are necessary conditions to secure political survival, so that reform efforts

[62] The Japanese version is even stronger: Ogawa stated that "the current Bank of Japan Law is not harmful for the BOJ" ("…*genkôhô ni shishô ga aru to ha omowanai*") (Nikkei, 9 April 1996) or ("*genkôhô de koremade tokudan no shishô ha naku, tadachi ni kaisei suru hitsuyô ha ijite inai*") (Yomiuri, 9 April 1996).
[63] "*zaisei, kinyû seisaku ha ittaiteki ni unei shite hajimete kôkateki na keizai unei ga dekiru*" (Nikkei, 6 April 1996.
[64] For instance, Yanagisawa Hakuo and Yosano Kaoru. In addition, Chairman of the Policy Research Council, Yamasaki Taku, argued that the MOF should maintain a certain amount of control over the BOJ (Brown 1999: 174-190; Lukauskas and Shimabukuro 2006: 132-133).
[65] See, section 4.3.6.3 about the issue of *jûsen*.

could be continued (Mabuchi 1997: 141-142; 164; Svensson, Mabuchi and Kamikawa 2006: 62-63).

The Ministry tried to exercise influence on the Bank of Japan Law making process in an active way. However, MOF bureaucrats lobbied not only LDP politicians, but also members of the Prime Minister's advisory council, the Central Bank Study Group, and tried to induce them to oppose the reform process. In addition, the chairman of the Project Team Itô argued that the "plan for abolishing the MOF's Banking Bureau caused immense resistance from the MOF. Itô complained about the attendance of MOF officials during the meetings, who "come so often to explain that we need to bar the door", and, as a consequence, the relationship between Itô and the MOF became ill-disposed (Mabuchi 1997: 164, 173; Volz and Fujimura 2008: 6) Thereafter, Itô threatened to resign, because he was extremely troubled with being subjected to constant pressure by the MOF. LDP's Secretary General Katô Kôichi intervened and successfully avoided a political impasse by criticising the MOF for exerting such a strong influence on the discussion by means of "intense lobbying and waging a campaign of disinformation" (Malcolm 2001: 348).

The MOF's real position (*honne*) towards the Bank of Japan Law revision process was alarming. In reality, some MOF officials were quite upset about the development regarding the independence of the BOJ. Before the revision of the Bank of Japan Law was agreed upon in 1997, the MOF organized a conference (*benkyôkai*) with the topic "Which problems is the MOF facing?" (*ôkurashô ha dô iu mondai ga aru*?). Japanese banking experts were invited, but most participants of the conference were MOF officials. The vast majority of visiting guests were surprised how blunt and open some MOF bureaucrats talked about their bad feelings concerning the recent development of the MOF and BOJ reform process. One official from the MOF banking bureau went so far as to state "Regarding the independence of the Bank of Japan, the law has changed, but in reality nothing has changed at all" (*nichgin no dokuritsu sei ni tsuite honshitsu ha ima to kawarimasen*).[66]

[66] Interview with former Bank official, 2008.

Commenting the now independent BOJ, one former MOF official argued that the "BOJ reform [was done] with regret"[67]. Similarly, Finance Minister Mitsuzuka Hiroshi[68] argued that the FSRC draft on central bank reform "was a total defeat for the Finance Ministry bureaucrats" (Grimes 2001: 206; Yomiuri, 11 February 1997). Regardless of these kinds of statements, the MOF was quite successful in influencing the process of central bank reform in its favour. Achievements of MOF lobbying included the limitation of only three BOJ members in the nine-member Policy Board (Mabuchi 1997: 70). Nakakita Toru of Toyo University believes that the MOF was involved in behind-the-scenes influencing, and, finally successful concerning, for example, the finance minister's supervisory right and the right to approve the Bank's annual budget (Brown 1999: 74; JT, 13 November 1996).

3.6.3 State Actors (2) – Political Parties

In regards of reforms, Reed and Thies (2001) argue that almost all political parties from both the ruling coalition and the opposition were generally supportive of reform movements as part of their political strategy. Regarding the issue of central bank law reform, the case was more ambiguous as this section will work out.

3.6.3.1 The Liberal Democratic Party (LDP)

The position of the LDP as the largest and most important party demands special attention in the analysis of the reform. It turned out that the opinions in the LDP were split concerning the subject of financial reform and an institutional change of the central bank. Some influential lawmakers, such as Katô Kôichi, Shiozaki Yasuhisa, a former BOJ official, and Mizuno Kiyoshi, fervently advocated a break-up of the MOF with an independent central bank (Mabuchi 1997: 136-138; Toya 2006: 162-165). However, in contrast, Yanagisawa, a former MOF bureaucrat, strongly opposed central bank independence (Mabuchi 1997), and other LDP lawmakers even considered reform plans as "totally impossible" (*totemo muri*) (Yamawaki 2002: 99). In addition, influential Project Team member Yosano Kaoru's position was close to that of the MOF and many party members followed him in supporting the Ministry.

[67] Interview with former MOF official, 14 July 2008. This narrative is known only among MOF and banking circles.
[68] In November 1996, Mitsuzuka succeeded Kubo as Finance Minister.

Due to these differing views the LDP was unable to reach a consensus concerning the questions of how and to what extent the reform of the Ministry should be realized. However, in the end, a concern for political survival guided the behaviour of the LDP towards reform. It integrated the reform-boosting image of its coalition partners, particularly the Sakigake, into its own political program. In the absence of fierce electoral competition, the LDP may have preferred different options, reflecting its privileged status within bureaupluralism; however, the electoral dynamics at the time motivated the majority of the LDP to follow the positions of its coalition partners (Toya 2006: 155-163). Opportunists who sought the particular goal of election success as priority were in the vast majority in comparison to the group of true reformers. As a result, a majority of LDP lawmakers preferred a rather cosmetic reform of the MOF. Therefore, the party was criticised by the public and media for its "halfway measures" in reform (Curtis 1999: 39).

Prime Minister Hashimoto

Due to his former position as a finance minister between 1989 and 1991, Prime Minister Hashimoto had close ties to the Ministry of Finance and was reluctant to cut the power of the prestigious ministry. However, two lines of reasoning are said to have changed his mind to increase the effort towards reform: First, the arrogant and aggressive behaviour of the MOF which fuelled his irritation and frustration. Second, Hashimoto regarded MOF reform as a strategy which increased the possibility of success for the upcoming election (Mabuchi 1997: 36; Nakakita 2001: 83). That is the reason, why, for instance, Cargill, Hutchison and Itô (2000: 93-94) emphasize the leadership role of Prime Minister Hashimoto as a key person for promoting financial reform and central bank reform.

However, according to other sources, Prime Minister Hashimoto's effort to reform the MOF was half-hearted, and he tried to protect the MOF from the coalition partners' efforts to disassemble the Ministry (e.g. Lukauskas and Shimabukuro 2006: 135). Although, by announcing the "big bang" (*biggu ban*) reform in November 1996, he also tried to weaken stronger efforts of certain reform-willing LDP politicians and the Sakigake to reform the Ministry. The Prime Minister countered an attempt of lawmakers in his own party to conduct central bank reform mainly under the management of the ruling coalition (Nakakita 2001: 73). Hashimoto has tried to limit

the influence of stronger reform-minded lawmakers by arguing that "because the BOJ is a neutral organisation, I do not want that central bank reform will be conducted under the leadership of political parties" (Asahi, 21 June 1996).

Instead, as shown in this thesis, Hashimoto organised a private council to do research about central bank reform. There are serious doubts whether or how far this private council was independent as, for instance, Tachi Ryûichirô the Chairman of the FSRC was a member in this Study Group.[69] That is, for some time, the LDP was successful in protecting the MOF. However, the situation changed before the general election in October 1996 and the Prime Minister regarded central bank reform as an important issue in political agenda (Amyx 2000: 7; Cargill, Hutchison and Itô 2000).

Did the LDP Really Seek an Independent BOJ?

An essential question is how serious were the efforts of leading LDP politicians to grant the Bank of Japan independence. This thesis provides ample empirical evidence that the majority of politicians did not want an independent central bank.

Numerous LDP politicians seemed to distrust the BOJ, and desired to augment their own influence over the important tool of monetary policy. Prime Minister Hashimoto has emphasized the need of cooperation between the BOJ and the Diet. Additionally, he argued that the Bank of Japan's monetary policies should match the government's economic policy. Prime Minister Hashimoto sought to shift power away from bureaucracy to the Prime Minister's Office (*kantei*) with the aim to strengthen his own power and to weaken the bureaucracy (Curtis 2002: 12). In addition, Hashimoto tried to increase the power of the Prime Minister and the Cabinet with the formation of the Council of Administrative Reform in 1996[70] [71] (Hirashima 2004: 46; Kamikubo 2010: 57; Köllner 2006: 291; Noble 2001: 27; University of Tôkyô 2006: 17). Thus, it can be argued that the central bank reform in Japan was motivated by politicians' incentive to cut the power of the MOF, and to limit the Ministry's influence on monetary policy, while simultaneously augmenting the power of the Diet over the BOJ (Oritani 2010: 16;

[69] The MOF even recommended Tachi as Chair of the Study Group (Nikkei, 30 July 1996).
[70] As a result of this effort, the Cabinet Office was established in 2001, including the Council of Economic and Fiscal Policy (CEFP) in order to strengthen the power of the Prime Minister regarding economic and fiscal policies.
[71] The LDP's Administrative Reform Promotion Headquarters (ARPH) worked on issues such as MOF reform and Bank of Japan Law revision (Toya 2006: 127).

Nakakita 2001: 65; Lukauskas and Shimabukuro 2006: 136). This argument lends support to the view that many LDP lawmakers did not necessarily seek an independent central bank, but rather sought to weaken the MOF.

Another critical argument is the fact that in the past, the LDP has ceded control over financial matters to bureaucracy to a high extent, in particular to the MOF. This was a strategy to avoid responsibility for the costs of policy practices that impose harm on loyal interest groups (Katô and Rothstein 2006: 88). That is, the LDP had already delegated control over monetary policy to an agent, the MOF, a long time ago (Cargill, Hutchison and Itô 1997: 190; Mabuchi 1995; Svensson, Mabuchi, and Kamikawa 2006: 62-63). It can be argued that with the central bank reform the government regained some of its control over monetary policy. In Japan's case, by means of delegation to an independent central bank the government gained power instead of giving it away.

Based on the previous arguments, it can be stated that the Japanese government never intended to grant the BOJ independence.[72] In that case, central bank independence was just a form of camouflage for the intention of stronger political leadership. Wagner (1999) analyses central bank independence in transition countries, and points out that central bank independence might merely be of symbolic character. If central bank reform had been implemented in an indifferent manner or, if this independence had been jeopardized by leading politicians from the very beginning, central bank independence could have even been counterproductive. Of course, Japan is not a developing country, but Wagner's argument bears some logic in the Japanese case. The behaviour of the Japanese government coincides with the new institutionalism approach by McCubbins, Noll, Weingast (1987), which argues that lawmakers try to limit the independence of newly autonomous agencies by inflicting procedural and institutional limitations. The government seek to maintain control over these agencies.

Another empirical evidence that politicians did not seek an overly independent BOJ is the fact that several politicians tried to interfere in right after the BOJ was granted independence, which many case studies verify. For instance, Pascha (2005a: 21) argues

[72] It can be argued that politicians did not respect central bank independence and believed that the BOJ should follow the instructions of politicians (Interview with former Ministry of Finance official, 14. July 2008).

that "[r]ight from the beginning of the new Bank in 1998, the government made it clear that it still wanted to retain an influence on monetary policy-making, pressing the BOJ to loosen monetary policy further."

The study of transcripts of Monetary Policy Meetings of the Policy Board demonstrates that the representatives of the government already put high pressure on the BOJ since the first Monetary Policy Meeting on 9 April 1998.[73] Certain lawmakers even demanded the law be amended again, and especially the BOJ showed signs that it did not intend to fully cooperate with the government.[74] The second indicator is the choice of Hayami Masaru as Governor, who was regarded as easy to influence by the government. Third, certain LDP politicians complained about the draft of MOF's FSRC. They requested more responsibility of the BOJ before the Diet be clearly formulated in the law, and desired a strengthening of the power and influence of the Diet (JT, 15 February 1997; 22 February 1997). Furthermore, the process of Bank of Japan Law revision demonstrated that many LDP lawmakers were not convinced by an independent central bank, and simply agreed to central bank reform in order to secure political survival, and to retain power of the existing ruling coalition. They would have preferred a dependent central bank, but were convinced it was a wise strategy to sacrifice it for a higher political goal. In other words, only very few lawmakers, such as Katô and Shiozaki supported BOJ Law revision and central bank independence, and not the whole LDP.

3.6.3.2 The New Party Sakigake

The New Party Sakigake was formed in 1993 by a group of LDP defectors under the leadership of Takemura Masayoshi. After the collapse of the Hata Cabinet in 1994, the Sakigake started a coalition with the LDP and the JSP and Takemura was promoted to Finance Minister. Efforts to reform the Ministry of Finance were clearly regarded as "dismantling the MOF" (*ôkurashô kaitai*), which was Takemura's slogan during his term as Finance Minister.

Influential Sakigake lawmakers, who were on the forefront of fighting for a restructuring of the MOF and central bank reform, included Hatoyama Yukio,

[73] See, section 8.7.4.4 and comments by Finance Minister Matsunaga and Omi Kôji, Economic Planning Agency, in Bank of Japan 2001, MPM 9 April 1998.
[74] For details, see Chapter 8.

Sakigake's representative Secretary General, Igarashi Fumihiko, member of the Project Team and Tanaka Shûsei. Sakigake politicians "took the most aggressive attitude" towards a break up of the Ministry.[75] For instance, the party threatened to break up the ruling coalition if MOF reform was not put into practice (Hori 2005: 127; Mabuchi 1997: 185). During the reform process, an executive of the Sakigake stated that "the party cannot yield to the matter of separation [between the Ministry and the central bank]" (Asahi, 5 June 1996). However, the resolutely reform-minded Sakigake was the smallest partner in the three-party coalition. In the October 1996 general election, the LDP gained a victory, but SDP and Sakigake suffered devastating losses, deciding to withdraw from the Cabinet. In order to keep the majority in both houses of the Diet, the LDP preserved the support of the SDP and Sakigake (Hori 2005: 124; Kishimoto 1996: 136). The Sakigake held only nine seats out of 511 in the Lower House, and had only a remaining two seats after the October 1996 election. With respect to the small amount of power regarding the number of seats, the Sakigake party was trying to prevent being overwhelmed in the coalition (Toya 2006: 174-175). Pushing for reforms can be understood as the party's manoeuvre to win the support of the electorate, and for political survival, and to retain power. In this sense, some scholars argue that the Sakigake, with its firm anti-MOF attitude constantly pressing the LDP towards reform played a key role for central bank reform in Japan (Brown 1999: 188-191; Hiwatari 2000; Mabuchi 1997).

3.6.3.3 The Social Democratic Party

The LDP's two coalition partners, the Sakigake and the Social Democratic Party (SDP, *Shakai Minshutô*),[76] were often cited collectively in the function of playing a major role in the reform process in which the BOJ was finally granted independence. However, Mabuchi (1997: 138-141) argues that the position of the SDP regarding reform was, unlike that of Sakigake, rather unclear.

A key person for advancing reform was Itô Shigeru, SDP policy research chief and chair of the Project Team for administrative reform, who put the issue of central bank reform on the agenda of the Project Team. A major question is, how the coalitional

[75] Grimes (2001: 207) describes the Sakigake party as "the most gung-ho advocates of radical reform".
[76] In January 1996, the SDP decided to change its name from Nihon Shakaitô (Japan Socialist Party) to Shakai Minshutô (Social Democratic Party) (Katô and Curtis 1997: 41; Kishimoto 1997: 149). To avoid complications, this thesis congruently uses the term Social Democratic Party (SDP).

parties gained relatively extensive influence in the reform process and in the Project Team considering comparatively small number of seats in the Diet. The answer is two-folded. First, the Project Team was characterized by an over-proportionate allocation of members from the SDP and Sakigake. As shown in section 3.5, only ten out of 21 members were LDP politicians. According to Hori (2005: 126-127), in order to sustain the governing coalition, ruling-parties organisations were built in a way that the LDP could not achieve a majority. In other words, in comparison to the number of their seats in the Diet, Sakigake and SDP could exercise a large amount influence, and, with their majority in the Project Team (eleven votes versus ten votes) exert considerable pressure on the LDP to support financial reform. Second, the fact that the chair was filled with a Social Democrat made it complicated for the LDP to control the procedure of reform. The rationale behind the choice for Itô had two reasons. First, a LDP-chaired project team was considered as inappropriate to call for MOF reform. The LDP had many Diet members with a MOF background, a fact that strengthens the impression of a "conspiracy reform" (*nareai kaikaku*) if the LDP would have taken the chair. Second, Itô was regarded as a person with profound knowledge of the MOF and good contacts to, for example, the LDP Secretary General Katô, which made him well respected in the coalition (Mabuchi 1997: 134-141; Yamawaki 2002: 99).

In January 1996, the prestigious post of Finance Minister was represented by a Social democrat, Kubo Wataru. In general, Kubo was regarded as supportive towards Bank of Japan Law revision and central bank independence (Hiwatari 2000: 126). For instance, Kubo claimed that it is important for a central bank to have independent authority in determining monetary policy. During a press conference on 22 May 1996 Finance Minister Kubo spoke in favour of investigating the reform of the BOJ further and called for more central bank independence.[77] According to Yomiuri Shinbun (23 May 1996), this was a remarkable change in the attitude of the ministry, since it was the first time that the Finance Ministry did not oppose central bank reform categorically. However, Mabuchi (1997: 141; 162) views the role of Kubo much more critically. After criticizing the Ministry once, Kubo had never repeated his critique or announced concrete plans for reform. His position was rather ambiguous and ill-defined. Arguably, Kubo had to be very careful in his actions as the highest person of the MOF. Altogether,

[77] The Finance Minister went so far to argue that there is no need that the government maintain its right to dismiss the central bank's key staff.

Kubo's "moral support" for Itô's efforts to push towards reform was low, and his influence for central bank reform was minimal. To lend support to this argument, *Asahi Shinbun* (13 May 1996) reported that the financial and central bank reform efforts made by the SDP and Kubo, Finance Minister from January 1996 to November 1996, were rather "slow" (*nibui*). In sum, the SDP was supportive towards central bank reform even if its position was less strong in comparison to that of the Sakigake.

3.6.4 Private Actors: Interest Groups

The most important interest groups representing Japanese industry are the Japan Federation of Economic Organisations (Nippon Keidanren), the Japan Federation of Employers' Association (Nikkeiren), the Japan Chamber of Commerce and Industry (Nihon Shôkô Kaigisho), and the Japan Association of Corporate Executives (Keizai Dôyûkai). Among the four, only Japan's most powerful business federation, the Japan Federation of Economic Organisations (Nippon Keidanren) was interested in greater central bank independence. In fall of 1996, the organisation published a paper calling for greater central bank independence.[78] However, the claim for central bank reform came more than six months later after the start of the initiative from the government for central bank reform, i.e. the report of the Keidanren came at a time when the most crucial contents had already been decided upon by politicians.

Other organisations and important persons acted even more passive, and commitments towards central bank independence were rare. Even if there were statements towards an independent BOJ, the influence was rather limited. For instance, although the chairman of the Bankers' Federation and President of the Fuji Bank Hashimoto Toru called for more central bank independence in his last news conference as chairman, his speech went unnoticed (JT, 17 April 1996). Some statements were even rather cautious concerning central bank independence. Ushio Jirô, chairman of the Japan Association of Corporate Executives (*keizai doyûkai*), warned against hasty financial reform by stating that "it is dangerous to set on reforming the Finance Ministry alone simply because it has too much power". Regarding the issue of central bank independence, Ushio argued that the BOJ can only be independent if it stops "depending on the Finance Ministry" (JT, 20 April 1996). However, generally speaking, strong interest groups, such as the

[78] See, "Views on the Revision of the Bank of Japan Law", Keidanren, 17 September 1996.

banking sector, had little political influence in this period. The depressing condition of the banking sector during the 1990s made many banks dependent on the Finance Ministry, preventing these banks from an active demand for more central bank independence. In addition, in times of bank insolvencies and scandals, an active exertion of influence is particularly difficult. In sum, "interest groups were indifferent to the restructuring of the financial bureaucracy." (Hiwatari 2000: 110-113; Malcolm 2001: 94-101).

3.6.5 The Role of Mass Media

According to Mabuchi (1997: 28-36), the role of mass media in prompting reform by constantly pressing politicians for reform was significant. The public was furious about scandals in the MOF (see, Chapter 8.5.1.1), and demanded mass media to launch a campaign towards MOF reform. Hori (2005: 121) finds that the Japanese media called for MOF reform already in 1995. For instance, the *Asahi Shinbun* (31 December 1995) stated that "[i]t is time to settle structural problems of the MOF […] we should discuss the reorganisation of the MOF […]". In addition, the media, in favour of a separation of the MOF, unsatisfied with the progress of MOF reform exercised "heavy pressure" on the chair of the Project Team Itô and other politicians, who were too soft towards the MOF, to speed up reform (Hori 2005: 122; Mabuchi 1997: 36; Toya 2006: 162-163). The daily newspaper *Mainichi Shinbun* published some provocative articles, and criticised the work of the FSRC (for example, on 14 January 1997, 19 January 1997, and 1 February 1997). In sum, the majority of media was in favour of central bank reform and tried to influence politicians to continue their effort on the path of reform.

3.7 Conclusion

This chapter analysed the process of the Bank of Japan law revision. After failing attempts in the 1950s and 1960s, it was not before 1996 until a new initiative for central bank reform has started. The Project Team for financial reform under the leadership of Itô and the Central Bank Study Group with the Chairman Torii were assigned with the task of central bank reform. This thesis demonstrated that the influence of the Ministry of Finance during the reform process was strong and that their demands had a lot of influence of the contents of the new Bank of Japan law. That is the reason why the process was criticized, e.g. by Mikitani (1996, 1997). This thesis found that the Bank of Japan and the then-Governor Matsushita were relatively unambitious to fight for a

higher amount of central bank independence. The behaviour of the leading party LDP let to the conclusion that the majority of the politicians were not overly interested in an independent central bank, but rather attempted to increase its own influence on the central bank and monetary policy.

After the investigation of the process of the central bank reform, including the standpoints and roles of the main actors, the following chapter will focus on explanations of central bank reform, applying existing delegation theories to the Bank of Japan.

4. DELEGATION TO AN INDEPENDENT CENTRAL BANK – EXPLAINING CENTRAL BANK LAW REFORM IN JAPAN

4.1 Introduction

> "Politicians are generally happy to exercise their power to decide things. Monetary policy is perhaps the most glaring exception. Delegation to an independent central bank is now the norm." (Crowe 2006: 3).

This chapter focuses on the decisions made by politicians to cede authority to independent agencies, and summarizes theories that explain why politicians in many countries have delegated monetary policy to independent central banks since the 1980s. According to the theory of public choice, politicians are assumed to maximize their own utility: thus, upon first sight, it seems illogical for politicians to relinquish such a powerful tool as monetary policy. This chapter aims to clarify this subject by analysing various delegation theories.

From a social welfare standpoint, it is beneficial to transfer power from politicians to bureaucrats in the following cases: if (I) the tasks require a high extent of specific technical ability, (II) the ex post preferences of the public are clear, (III) a high degree of flexibility is unnecessary, (IV) time inconsistency is a problem, and (V) "powerful vested interests have large stakes in the policy outcome" (Masciandaro et al. 2008: 834; Alesina and Tabellini 2004: 4-5). Taking these criteria into account, Alesina and Tabellini (2007, 2008) conclude that monetary policy qualifies for delegation to an independent agency, because it is characterized by highly technical issues, and career oriented bureaucrats might have superior incentives than politicians. Therefore, it can be argued that monetary policy should be delegated to independent central banks. Politicians' actions are often characterized by "myopic behaviour" that concentrates on short-term benefits (Bofinger et al. 2001: 209). Political decisions might threaten a positive outcome of economic resources, whereas the long-term time horizon of independent central banks makes monetary policy more efficient. Blinder (1998: 56-57) stresses that monetary policy needs long time horizons, and neither politicians nor the public have an understanding of long lags of monetary policy. Thus, independent

authority over monetary policy might be beneficial for policymakers (Alesina and Tabellini 2004; 2008).[79]

Regarding the question of "why delegate", an extensive amount of literature has analysed the motivations behind principals' incentives to delegate functions and to increase the authority of agents. Delegation theory combines "several strands" of literature: mainstream macroeconomic literature on central bank independence, political science critique, rational choice theory, a more recent political economy that mixes components of both, a sociological view of ideas and epistemic communities, and parallel political science literature that takes a historical, case-study approach.

The following sections turn to an analysis of central bank independence and the rules versus discretion debate in monetary policy. This is followed by an examination of delegation theories that help to explain why governments grant their central banks independence.

4.2 Theories Explaining the Delegation to an Independent Central Bank

4.2.1 Central Bank Independence and the Rules versus Discretion Debate in Monetary Policy

The subject of central bank independence has been debated since the foundation of the first modern central banks in Sweden in 1668 and England in 1694. Many popular economists, including Walter Bagehot, Irving Fisher, John Maynard Keynes, Friedrich von Hayek, and Milton Friedman have made notable contributions to and have extended the literature on central bank independence (Debelle 1994: 92-95).

The concept of independent central banks goes back to at least Jan Tinbergen (1954) who argued that existing conflicting economic goals must be dealt with by specialized, independent institutions. Since the 1970s and 1980s economists have founded the theoretical foundations of central bank independence (e.g. Kydland and Prescott 1977; Barro and Gordon 1983a, 1983b; Rogoff 1985). In the late 1980s and 1990s political economists started to define and measure central bank independence, concentrating on

[79] In contrast to monetary policy, Hüpkes, Quintyn and Taylor (2005) argue that in case for financial sector supervision politicians are generally reluctant to delegate to independent agencies. However, the delegation of monetary policy to an independent central bank requires the condition that society's preferences are well known and stable (Alesina and Tabellini 2004: 27; Alesina and Tabellini 2008: 434).

macroeconomic effects (Bade and Parkin 1988; Grilli et al. 1991; Alesina and Summers 1993). Later, political scientists focused on political aspects of central bank independence, "considering the incentives that political and socio-economic actors have in establishing an independent monetary institution" (Quaglia 2005: 550-551).

An important body of literature concentrates on the inflationary bias of discretion in monetary policy making. The inflation bias of discretionary monetary policy is the policymaker's incentive to accept an inflation rate higher than its optimal level in order to encourage economic growth (and/or a higher employment rate). The early literature of Kydland and Prescott (1977), Calvo (1978) and Barro and Gordon (1983a) focused on the time-inconsistency problem.[80] In a model describing a non-cooperative game between the policymaker (the central bank) and the private sector, Barro and Gordon (1983b) demonstrate the advantages of rules over discretion.[81]

The problem with politician's incentive to inflate the economy is that, under the assumption of rational expectations, the public anticipates the government's motivation. As a result, in the long-run, inflation rises above its natural rate. Hence, politically motivated intervention in monetary policy has detrimental potential to create boom-bust cycles that lead to an unstable economy. The optimal policy option of the government prior to policy implementation is not necessarily coherent with the optimal policy option after implementation. More precisely, there is an inconsistency in the government's best strategy over time, which is known as the time-inconsistency problem in academic literature. By controlling inflation rates, an independent central bank could prevent the government from causing inflationary shocks by insulating monetary policy from short-term political influence. This, in turn, has a stabilizing effect on the economy.[82] Rogoff (1985) demonstrates that the appointment of a conservative central banker, who places a higher weight on inflation aversion than society, can avoid the inflationary bias problem, and reduce the time-inconsistency

[80] An introduction of the rules versus discretion debate can be found in Bofinger et al. (2001: 164-204, chapter 6).
[81] Bofinger et al. (2001: 185-198) analyse some limitations of the simple Barro-Gordon model, coming to three conclusions: First, the assumption that the central bank seeks a lower unemployment rate then the natural rate is doubtful. Second, the result of a repeated game might differ to the one of a one-period game and, third, the assumption of complete information and the neglect of stochastic shocks are overly simplifications.
[82] In contrast, some economists argue that central bank independency is neither necessary nor sufficient to fight inflation (e.g., Posen 1993, Hayo 1998).

problem. Lohmann (1992) extends Rogoff's analysis by adding the possibility of an override mechanism of the central bank by the policymaker in periods of large output shocks, and concludes that a partially independent central bank is a better solution than a fully independent central bank.

In contrast, several scholars have been critical of the academic literature on time-inconsistency, claiming that this approach lacks accuracy in describing the policy process of monetary policy (e.g. Blinder 1997; McCallum 1995, 1997b). For instance, McCallum (1995; 1997b) argues that central banks consider higher inflation as a bad equilibrium and, as a consequence, can be trusted not to inflate the economy. In another example, Blinder and Rudd (2008) find that the rise in inflation can be explained through supply shocks rather than inflationary bias of discretionary monetary policy. In addition, some practical central bankers, such as Blinder (1997: 13-14) and Greenspan (2007) criticise the academic literature, and argue that time inconsistency "is a nonproblem in the real world" of modern central banks, because central bankers have simple tools to solve this. Accordingly, several authors claim that time inconsistency cannot be the sole motivation for delegation, but rather must be added to other factors, especially political economy reasons (Alesina and Tabellini 2008; Crowe 2006; Cukierman and Gerlach 2003; Goodman 1991; Lohmann 1998).

4.2.2 The Macroeconomic Theory: Low Inflation and Central Bank Independence

Based on a macroeconomic perspective, many scholars view delegation to an independent central bank as a solution to the time inconsistency problem[83] based on the finding of a robust, negative correlation between central bank independence and inflation (Berger, de Haan and Eijffinger 2000; Cukierman, Webb and Neyapti 1992; Grilli, Masciandaro and Tabellini 1991; Cukierman 1992; Hayo and Hefeker 2002, de Haan, Masciandaro and Quintyn 2008).[84] [85] In their landmark paper, Alesina and

[83] A fixed exchange rate system is another solution strategy.
[84] Restrictively, Cukierman (2005: 44-45) argues that, in contrast to industrial economies, the relation between central bank independence and inflation is unclear in the case of developing countries. In addition, he highlights the difference between legal and actual independence, which conceivably could diverse a lot. Cukierman (1994) also demonstrates that in industrial countries inflation has no correlation to de facto indices, especially the turnover rate of Central Bank Governors.
[85] According to Alesina and Summers (1993: 159), central bank independence may be an endogenous variable. They recommend considering the "joint endogeneity between economic outcomes and institutions" in the "analysis concerned with the long-term evolution of institutional arrangements". As a consequence, it could be argued that a negative correlation between inflation and central bank independence is not robust.

Summers (1993: 154) even find "a near perfect negative correlation" between central bank independence and inflation. In addition, some of the existing research suggests that central bank independence delivers lower inflation and enhanced financial system stability as a "free lunch".[86] This refers to the assumption that the benefits of lower inflation can be achieved without any real additional economic costs in terms of macroeconomic performance, such as output and employment volatility, or reduced economic growth (Alesina and Summers 1993; Alesina and Gatti 1995; Grilli, Masciandaro and Tabellini 1991; Eijffinger, Van Rooij and Schaling 1996).

The literature about central bank independence[87] and low inflation typically emphasizes the government's pre-electoral tendency to seek low interest rates or surprise monetary shocks in order to generate politically expedient temporary booms in the economy. The obvious objective of policymakers is to enhance the governing parties' re-election prospects. Eventually, dependent central banks, which are subject to short-term political influence, may over-stimulate the economy to augment short-term output and employment. An independent central bank may have the credibility[88] to prevent politicians' incentives to inflate the economy. Some political economists have argued that "the anti-inflationary value of an independent central bank depends on the degree of inflationary pressures faced by the government: the higher the inflationary pressure, the more incentive to adopt an independent central bank" (de Haan and Van't Hag 1995; Franzese 1999).

4.2.3 Political Economy (1): Partisan Theory

One group of political economists argues that government partisanship affects economic policy preferences, meaning the economic objectives of the government form the outcome of monetary policy. Assuming a perfect Phillips-curve trade-off, the literature

[86] The concept of a "free lunch" is discussed controversially in the literature. Some economists have found the existence of costs with the delegation to an independent central bank, including the reduction of welfare and higher output costs during disinflations (e.g. Alesina and Gatti 1995; Debelle 1996; Down 2004). However, it is widely regarded that the benefits of an independent central bank exceed the potential costs (e.g. Alesina and Summers 1993; Bernanke et al. 2001; Cukierman et al. 1993).

[87] Following the practice of the literature, this thesis applies the terms of "autonomy" and "independence" alternatively. However, being more precise, autonomy involves "operational freedom", whereas independence is the "lack of institutional constraints." (Laurens et al. 2009: 6)

[88] If credibility is the reason to delegate, the principal will choose an agent with different goals. That means the government appoints a central banker who is more conservative than himself. Political economists argue that this choice of delegation is an example of the violation of the "ally principle", which implies that principals prefer agents with similar ideologies (Bendor and Meirowitz 2004; Bendor, Glazer and Hammond 2001; Huber and McCarty 2004).

dealing with the partisan theory highlights different policy preferences concerning macroeconomic outcomes by left or right parties.[89] More generally, the traditional partisan model assumes that rightwing parties place emphasis on price stability and a greater role for the market whereas leftwing parties prioritise low unemployment, government intervention and income redistribution (Hibbs 1977; Hibbs et al. 1982; Oatley 1999; Alesina 1988; Alesina and Gatti 1995; Alesina and Sachs 1986; Havrilesky 1994: 116-117).[90]

In comparison to the political business cycle model of Nordhaus (1975),[91] [92] the partisan theory assumes that policymakers do not behave opportunistically, but rather choose economic policies according to ideology-specific preferences. The partisan theory has found some support in empirical studies. For instance, Garrett (1998) has demonstrated that leftist governments may cause higher economic growth and lower unemployment with higher inflation under high capital mobility. Rational partisan models have recently been enlarged to explain central bank reform (Boylan 2001: 29). The partisan theory suggests that right or conservative governments which are highly concerned about controlling inflation are more likely to campaign and delegate monetary policy to an independent central bank than left-of-centre governments (Goodman 1991).

However, regarding central bank reform, empirical studies demonstrate numerous examples of conservative governments which choose not to delegate. Bernhard (1998: 317-318) finds no evidence of a "statistically significant relationship between partisanship and central bank independence", but rather that moderate leftist parties are connected to high degrees of central bank independence. In addition, government

[89] A useful summary of the partisan literature can be found in Alesina, Roubini and Cohen (1997), Belke and Potrafke (2012) and Drazen (2000).

[90] The rational partisan model assumes that clear partisan outcomes do not exist in the long run, because rational agents anticipate the government preferences and adjust their behaviour to new conditions (Alesina, Roubini and Cohen 1997). In addition, Boix (2000) and Oatley (1999) demonstrate that partisan differences in policy instruments (and not policy outcome) depend on the combinations of capital mobility and exchange-rate regimes (Sakamoto 2005). Clark and Hallerberg (2000) come to opposite conclusions.

[91] According to this model, opportunistic politicians try to decrease the unemployment rate before elections in order to increase their chances of re-election. This conclusion is based on three assumptions: 1. Macroeconomic policy is not neutral, 2. Economic outcomes are essential outcomes of voter behaviour and 3. Politicians use this non-neutrality of macroeconomic policy for their own benefit (Alpanda and Honig 2010).

[92] The assumptions of the public's adaptive and non-rational expectations of Nordhaus' political business cycle model have been criticised. With the adoption of rational voters – voters are rational and seek to maximize their utility –, Persson and Tabellini (1990) have complemented the political business cycle model.

partisanship fails to explain the vast variety of central bank independence, the timing of central bank reform, and cannot explain the correlation between federalism and central bank independence (Bernhard 2002: 8-9). A recent study by Belke and Potrafke (2012) confirms this straightforward argument, veryfying that short-term nominal interest rates were higher under the rules of leftist governments, which leads to the conclusion that influence of government ideology on monetary policy might cast doubts.

4.2.4 Political Economy (2): The Uncertainty Argument: "Tying the Successor's Hands"

Contemporary theories of bureaucracy provide an interesting approach to explain politicians' motive to delegate. The enacting legislative coalition implements bureaucracies in a way to protect their own policy preferences and to hinder succeeding governments to implement changes. Owing to the fact that any given government expects to be in power only for a limited period of time, politicians try to exert control even after the loss of power, and attempt to limit the influence of following administrations (Horn and Shepsle 1989; McCubbins, Noll and Weingast 1987, 1989; Moe 1990: 227-228). Voigt and Salzberger (2002: 296) add that this strategy of delegation is connected with very low costs if the constraining consequences of delegation become effective only in the future. Oritani (2010) adds an important argument, namely that delegation can be a means of a ruling government to "protect" the electorate from unpopular policies that might take place in the future:

> "The legislature and voters (interest groups) also have a tendency to favor extending a certain level of autonomy to bureaucratic organizations as a countermeasure against political uncertainty. By insulating bureaucratic organizations from the legislature, even if there is a change in regime, the new power cannot easily implement a bold and unfavourable policy through such autonomous bureaucratic organizations" (Oritani 2010: 15).

Regarding central banks, Goodman (1991: 330-334) observes that if a government with a preference for low inflation expects to lose power, legislators try to limit the successor's policy choices by delegating monetary policy to an independent central bank.[93] The party - or coalition - currently in power tries to 'tie the hands of its successor', and delegation of power to an independent central bank can be considered as

[93] Goodman (1991: 334) adds that a dominant societal coalition, i.e. the financial sector, is a necessary condition for central bank independence.

a type of "self-protection" by politicians (Moe 1990). In an environment of competing political parties, autonomous central banks reduce electoral uncertainty about future monetary policy (Alesina and Gatti 1995). As a result, countries with a high extent of political turnover are expected to be more likely to delegate power to independent central banks in contrast to countries with a high political stability (Bagheri and Habibi: 1998; Goodman 1991; Boylan 2001).[94]

Lohmann (1998) investigates the politics of the German Bundesbank, and argues that political uncertainty is a sound explanation for delegation since politicians anticipate that they will be out of power in the future. Bernhard (2002: 33), however, criticises that the 'tying the successor's hands' argument proposes more variation in central banks than is actually observable. The hypothesis suggests that 'new' governments should have changed the central bank law in order to meet their own preferences, but, in fact, this strategy was avoided by many governments. Rather, Bernhard (1998: 317-320) finds that low levels of polarization[95] correlate with high degrees of central bank independence, a clear contradiction to Goodman's observations as the 'tying the successor's hands' approach assumes that the level of central bank independence should be higher in polarized systems.

4.2.5 Political Economy (3): Interest Groups

Active lobbying by interest groups is another possible explanation for bureaucratic restructuring and delegation. By mobilizing lawmakers powerful interest groups might form new agencies (Moe 1989, 1995). The interest group argument is based on two major assumptions: First, there is the concentration of domestic aspects with the almost entire exclusion of international factors. Second, this concept focuses on the importance of demand-side pressures in the process of institutional reform: Powerful interest groups, such as the financial sector, industry or unions are the driving forces towards reform (Posen 1993, 1995b).

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[94] De Haan and Van't Hag (1995) come to the exactly converse result. They use a data set of 22 industrialised countries and do not find a positive relationship between central bank independence and government turnover, or the equilibrium unemployment rate. Rather, they find a negative relationship between central bank independence and political instability.

[95] Bernhard (1998: 316) calculates polarization as the average percentage of the voters support for extremist parties. A high degree of polarization implies that party legislators and coalition partners will be less willing to penalize the government. Therefore, one should assume that polarization is negatively related to central bank independence.

Economic actors, who benefit from low inflation and price stability, include retirees, small savers and mortgage holders. However, the financial sector (banks and financial intermediaries) is the most essential interest group that fears inflation and prefers a conservative monetary policy. The financial sector is the sector that is affected most directly and constantly by monetary policy and, thus, is seen as the strongest advocator of central bank independence (Goodman 1991: 333; Havrilesky 1994: 126; Posen 1993, 1995b; Quaglia 2005: 553). Based on the above mentioned assumption, Posen (1993, 1995b) argues that political influence of the financial sector determines the central bank's degree of independence. The degree of central bank independence is regarded as a proxy of the strength of the inflation-opposing financial sector.[96] Regarding delegation to an independent central bank, the critical question is whether the financial sector's political influence is strong enough to organize a broad opposition to inflation.[97]

4.2.6 Political Economy (4): The Cabinet Stability Hypothesis

Bernhard (1998; 2002) focuses on politicians' incentives regarding the institutional structure of the central bank, and argues that governments confronted with intra-party or coalitional conflicts about economic policy seek to resolve these disputes by shifting power over monetary policy to an independent agency. In the 1990s, a trend towards party-system instability in many industrial democracies lead to an "increased potential for intraparty conflict over economic and monetary policy" (Bernhard 2002: 100), which supported central bank reform in many countries. Put another way, Bernhard's argumentation emphasizes the desire of politicians to maintain the stability of the ruling coalition. Politicians are likely to delegate monetary policy to an independent central bank (1) if government ministers, backbench legislators, or coalition partners have different monetary policy incentives, or (2) if government ministers, backbenchers or coalition partners can credibly threaten to withdraw their support or even punish the ruling government. In case of similar monetary policy preferences between government

[96] Other studies find less or no evidence for Posen's argument, for instance, de Haan and Van't Hag (1995), Campillo and Miron (1997) and Temple (1998).

[97] Another point of Posen's argumentation is that central bank independence led to a decrease of inflation in OECD countries if there is an agreement in the society that lower inflation is beneficial. As a consequence, it is useless to implement an independent central bank in a country in which the society does not prefer low inflation.

ministers, backbench legislators, and coalition partners, delegation is unlikely and the central bank will remain dependent upon political influence.[98]

Politicians' incentives are characterized by asymmetric information about the monetary policy process and, as a consequence, bear the risk of intra-party or intra-coalitional conflicts. An independent central bank can resolve this situation by disclosing information about government's policy decisions and potential mistakes. Generally speaking, in systems in which the government's information advantages are substantial and trigger various conflicts, lawmakers establish central bank independence. In systems with a low degree of conflict-potential, the opposite is the case and dependent central banks are preferred. In other words "the credibility of an independent central bank […] prevents intraparty conflict. As a result, parties remain in office longer, even if party politicians have different incentives with respect to monetary policy" (Bernhard 1998; 2002: 12; Bernhard and Leblang 2002).

4.2.7 International Political Economy

Another strand of literature analyses the worldwide trend towards central bank independence from the perspective of international political economy (Bernhard 1998; Boylan 2001; Maxfield 1997; McNamara 2002; Polillo and Guillén 2005). The main argument is that central bank reform towards more independence arises from globalisation pressures, mostly through the increasing importance of global financial capital. The increase of international capital movements forces politicians to implement policies and institutions that support an open market, including independent central banks (Bernhard 2002: 32; Goodman 1992). Maxfield (1997: 9) argues that the rationale behind this argument is that economic internationalisation "raises the cost of poor monetary policy and increases the value of central bank independence."

This means that politicians transfer independence to the central bank in order to signal their nation's anti-inflationary credibility to international capital markets. This move should attract financial investors and invite foreign capital inflows. When proceeding a step further, the "[f]ear of losing international financial resources lurks underneath the

[98] Bernhard (2002: 12-13) uses this approach to conclude that in federal systems, such as the U.S., Germany, or Switzerland, conflict over monetary policy is high, and, therefore, politicians are tempted to delegate monetary policy to an independent central bank.

proximate legal motivation for politicians to increase central bank independence […]" (Maxfield 1997: 56). Independent central banks are a means to guarantee the country's creditworthiness to foreign investors and to assure the value of their assets (Polillo and Guillén 2005: 1769).

However, the applicability of an important role of international factors to central bank reform seems limited. First and foremost, a correlation between central bank independence and international factors is not statistically robust.[99] Second, financial markets may indicate the need for financial reforms and changes, but it is false to conclude that they control the specific contents of reform. The international political economy approach assumes "a convergence across all states in the choice of central bank institutions" (Bernhard 2002: 33). However, because of considerable differences in timing and content of central bank reform across countries, the subject of central bank reform seemed to derive rather from "domestic political imperatives" (King 2005: 108). Third, various empirical studies have demonstrated that international factors cannot be generalized as the rationale behind delegation. In most cases, international political economy explanations fail to explain central bank reform in developed countries. Indeed, international explanations seem to explain central bank reform solely for developing and emerging countries.[100]

This section has summarized existing theories about delegation to an independent central bank. The following sections apply these theories to central bank reform in Japan.

4.3 Explaining Central Bank Reform in Japan

The main task of this chapter is to examine why political key actors in Japan decided to revise the BOJ's legal structure. The previous chapter summarized the most important theories that explain delegation to an independent central bank. The theoretical analysis from the previous chapter should direct to hypotheses which can be examined empirically to a case study, here the Bank of Japan.

[99] For example, Bernhard (1998) finds no correlation between economic openness and central bank independence for the period between 1970 and 1989.
[100] See, for example, Maxfield (1997) who analysed central bank reform in Brazil, Korea, Mexico, and Thailand, and Boylan (2001) who investigated central bank reform in Chile and Mexico.

Countries differ in regards of many institutional aspects, e.g., concerning the political system and monetary regime. This chapter focuses on the Bank of Japan as a case study. The 1998 Bank of Japan Law revision represents an opportunity to investigate institutional reform, since the driving forces behind BOJ reform illustrate different dynamics than those found in most other countries. Put differently, Japan is a crucial case study chosen to test contending explanations of delegation to an independent central bank. Comprehensive case studies can be understood as a tool to improve delegation theories. Following this reasoning, this thesis incorporates specific Japanese institutional contexts into the analysis of institutional reform. Existing delegation theories based on macroeconomic factors, partisan theory, interest-group lobbying and coalitional policies, which are briefly examined, are incorrect for the case study of the Bank of Japan. In other words, the central question is which determinants explain BOJ reform.

This thesis observes that the vast majority of existing literature about central bank reform does not explain why the Bank of Japan Law was revised in 1998. The primary objective of this thesis is to fill this gap. The objective is not only to identify which actors made central bank reform happen, but also to find out why the revision of the central bank law occurred at this particular time, why it was enforced as it was, and why the result obtained was as it was and not different.

4.3.1 The Macroeconomic Foundation and the 'Japan-Puzzle'

Based on the assumption of a negative correlation between central bank independence and inflation, one can argue that, theoretically, Japan must have experienced high inflation until 1998. The reason is that most central bank independence indices underline that the Bank of Japan had minimal legal independence before 1998, i.e. the BOJ was considered as one of the most dependent central banks in the world.[101] In reality, however, the situation was quite different. Throughout most of the post-war period, Japan enjoyed a sound and stable economic performance. The BOJ received credit and had a proficient reputation due to Japan's low rates of inflation coupled with

[101] A detailed analysis of central bank independence indices and Japan is presented in Chapter 5. For a useful summary, see Cargill, Hutchison and Itô (1997: 183-186; 2000: 85). Pascha (2005a: 10-11) compares main indicators of central bank independence for Japan before and after the law revision.

high and comparatively stable output growth.[102] The inflation performance of Japan was excellent from 1975 to 1990, which caught international attention, and demonstrated that price stability is achievable even with an institutionally dependent central bank. Since the beginning of the 1980s, Japan's inflation rate has declined significantly, even to a lower level than the rest of the world (Suzuki 1986: 105-109). According to IMF data, Japan's average inflation performance between 1980 and 1989 was 2.5 per cent, the lowest of all 18 tested industrial countries (Grilli, Masciandaro and Tabellini 1991: 344). Thus, the Japanese government had no rational reason to delegate more independence to the Bank of Japan in order to achieve low inflation rates, because Japan simply was not affected by high inflation before the reform process. Rather, Japan is often cited as a striking example that low inflation can be achieved even with a politically dependent central bank, referring to the so-called 'Japan puzzle' of low inflation performance (Cargill, Hutchison and Itô 2000: 111; Dwyer 2004: 249). As a consequence, Japan is often cited as counterexample to the macroeconomic hypothesis (Cargill, Hutchison and Itô 1997: 172-187; 2000: 89-112; Lohmann 1997; Walsh 1997). Thus, one has to search for different explanations for central bank reform in Japan.

4.3.2 Political Economy: Partisan Theory, Interest Groups, and Cabinet Stability

The partisan theory does not suffice to explain the timing and contents of central bank reform in Japan. Partisan theory suggests that conservative governments are more inflation-averse than leftist governments, and, therefore, are more likely to promote central bank independence. However, there is no evidence that partisan theory helps to explain an independent BOJ, because Japan's largest party, the conservative LDP, did not campaign central bank reform throughout the 38 years of LDP rule.

Some scholars have emphasized the immense influence of financial interest groups in Japanese politics (Rosenbluth 1989; Calder 1993). However, Moe's (1990, 1995) approach of interest groups forming new agencies, here an independent central bank, by mobilizing policymakers is not applicable in Japan's case, because this thesis has shown that the financial sector was not overly interested in central bank reform (see, Section 3.6.4). In addition, Posen's argument concerning interest group pressure ignores the

[102] Admiration for the BOJ was argued from more than one source. Keynesians honoured the BOJ for ensuing Keynesian policies and Milton Friedman characterized BOJ's monetary policies as "closest monetarists" (Rhodes and Yoshino 2005: 1).

impact of political actors. However, certain scholars have observed that politicians' behaviour was the driving force behind central bank reform in Japan (see, Chapter 3) (Hirashima 2004: 44; Mabuchi 1997). As a result, the interest group pressure argument is not applicable to the BOJ case study.

Regarding the Cabinet stability theory, Dwyer (2004: 251-252) cites Bernhard who argues that this model might not work in Japan, "because the number of coalition governments did not increase dramatically" before or during the period of central bank law reform. Rather, for the Cabinet instability hypothesis to work, one would have to pinpoint a central bank reform between 1993 and 1994, as this period was characterized by a high amount of coalition partners.[103] One can argue that the Cabinet stability theory model might work considering the extent of internal party conflicts within the LDP.[104] Indeed, LDP factions[105] play a significant role in Japanese politics. Nonetheless, there is no evidence that the attempt to avoid political disputes within the LDP was a reason for central bank reform in Japan. Rather, fierce conflicts between various factions were a common feature of LDP politics throughout its history (Curtis 1999: 66), without ever resulting in a revision of the Bank of Japan Law. Thus, the Cabinet stability hypothesis provides no evidence that Bank of Japan Law reform was caused by lawmakers' attempts to solve internal and coalitional conflicts. Further, this hypothesis fails to explain the timing of central bank reform in Japan.

4.3.3 The Credibility Argument

4.3.3.1 The Credibility Argument: Domestic

If applied to Japan, Goodman's (1991) theoretical assertion of "tying a successor's hand" suggests that LDP politicians expected to be in office for only a short term, and sought to limit future non-LDP governments' influence on the BOJ and monetary policy by implementing an independent central bank. However, this conclusion is not convincing. In fact, the LDP's political dominance strengthened the institutional subordination of the BOJ, and the LDP outsourced the complicated task of supervising

[103] The governments under Prime Ministers Hosokawa (August 1993 – April 1994) and Hata (April 1994 – June 1994) consisted of eight respectively six different coalition partners with substantial differences in their preferences and a high possibility of conflicts.

[104] Bernhard (1998: 315-316) points out that "large catch all parties [such as the LDP] or those with a wide range of class interests are more likely to suffer from 'incentive divergence', which occurs when politics that benefit one set of constituents impose costs on others."

[105] Kishimoto (1997: 134) offers a detailed genealogy of LDP factions from 1955 to the 1990s.

monetary policy to the MOF, with which the LDP formed a close relationship (see, section 4.3.5). Rather, this thesis argues that LDP politicians had no incentive to form an independent central bank, but rather preferred to exert control over the BOJ. Thus, the line of reasoning that LDP lawmakers shifted authority to the BOJ in order to limit the control over monetary policy of future governments "seems far-fetched" in the case of BOJ reform (Pascha 2005a: 23).

Credibility-based explanations as the fundamental rationale behind Bank of Japan Law reform cannot be backed up with evidence. In contrast, there are many arguments against a "straight credibility story" (Boylan 2004), leading to the conclusion that gaining credibility through central bank reform was not politicians' primary incentive to revise the Bank of Japan Law. Boylan (2001: 152) observes that "central bank autonomy would seem most necessary from a credibility standpoint when private sector confidence is lowest." However, private sector activity was not so low in Japan that politicians needed drastic measures to support domestic investment. There is no evidence that such a costly signal was a strategy chosen by Japanese lawmakers for domestic markets. If credibility was politicians' main incentive, then there would arguably have been a better timing for central bank reform. In addition, the private sector and the general public were not overly interested in central bank reform (Chapter 3.6.4). Pascha (2005a: 23) argues that the "public was not interested in autonomy as a value in itself, but in an economic improvement."

There are further arguments which undermine credibility argument. First, regarding the theoretical underpinning of the credibility argument, Boylan (2001: 30) states that "the credibility literature assumes that all politicians have the same incentives to undertake central bank reform". This means that there must be, at least, a certain degree of homogeneity between political actors. However, in contrast to this assumption, the Japanese example demonstrates that there were substantial differences within the largest party and the coalition in regards of the preferences. Second, it is a widely accepted fact in the academia that central bank independence does not enhance credibility if it can be easily reverted. For instance, Lohmann (1998) argues that the mere threat to revoke central bank independence can be an effective means for influence on the central bank's independence. In Japan's case, politicians started to pressure and attack the Bank of Japan very soon after the implementation of the new law, and, in very drastic examples,

even threatened to withdraw its independence (see, Chapter 8), which is an indicator that clearly contradicts credibility reasons for delegation.[106]

Third, if credibility is the primary reason for delegating authority, principals will most likely prefer agents who have different preferences. This kind of strategy breaks the so-called ally principle, which claims that principals prefer agents who resemble themselves ideologically. Principals suppose that conservative central bankers would improve the credibility of commitments of disinflationary policies. Therefore, it is a necessary condition to grant independence to the central bank (Aziz 2005: 538; Majone 2001: 104-116). However, the majority of Japanese politicians sought a central bank that has similar preferences and is easy to be controlled. Forth, because the Bank of Japan Law was outdated, it had to be revised sooner or later anyway. Why in 1997 of all years is not sufficiently explained by the credibility argument. Fifth, there was almost no public discussion about the Bank of Japan Law. Professionals and academics were, to a high extent, excluded from the reform process (Mikitani 1997). This procedure is not helpful to enhance credibility.

4.3.3.2 The Credibility Argument: International Political Economy

The credibility argument also reflects international implications. Some scholars argue that central bank reform did represent political needs to demonstrate credibility not only domestically but also internationally (Maxfield 1998). As already noted, since the 1990s, central bank independence has been regarded as a superior institutional framework, and was actively promoted by international organisations, such as the International Monetary Fund (IMF),[107] the World Bank, and the Organisations of Economic Cooperation Development (OECD) (Cukierman 2008: 726; McKinnon 2005). McKinnon (2005: 126) calls central bank independency the "new mantra" of the IMF and World Bank, because of their mission to advice, and, sometimes even, to pressure governments for independent central banks. However, in Japan's case, there is no evidence that central bank reform was imposed by international organisations such as the IMF or the OECD (Lukauskas and Shimabukuro 2006: 138).

[106] For instance, the government pressured the BOJ to increase the money supply in 1998, insisted on a purchase of Japanese government bonds (JGB, *kokusai*) in 1999 and opposed strongly the termination of the zero interest rate policy in 2000 (most strikingly, the government representatives in the Monetary Policy Board made use of the right of request a postponement of a monetary policy decision).
[107] Efforts of the IMF to campaign central bank independence include Romania (IMF 2004) and Turkey (Kiefer 2007) (in Garriga 2010: 49).

Some scholars, including Cargill, Hutchison and Itô (2000) and Dwyer (2004: 245; 257-259), claim that Japanese politicians chose central bank independence in order to reinstate domestic and international confidence. Moreover, they state that the content of the new Bank of Japan Law can be explained, at least partially, by lawmakers' effort to adopt international standards in the establishment of an independent central bank, or get closer to an Anglo-Saxon model of political economy. However, comparing the Bank of Japan Law with statutes of other major central banks demonstrates that the contents of the Bank of Japan Law has weak points and significant limits of central bank independence that do not necessarily meet international standard (Kanegae 1999: 90-116).[108] Thus, an argumentation that the adaption of international best practices was the driving force behind the contents of the new Bank of Japan Law is not convincing.

One might argue that the final report of the Prime Minister's advisory council, the CBSG (see, section 3.5.5), could be interpreted as evidence for the credibility argument. The CBSG's final report (1996) demands "fundamental reform" of the Bank of Japan Law and states that "in order to gain credibility from the global market" an independent central bank and a clear definition of its relationship to the government are essential factors. However, instead of a claim for a fully independent central bank, the second statement has to be interpreted as a request for a strong government. The CBSG report calls for not only a stronger cooperation between the government and the central bank, but also for governmental intervention. For example, the report argues that certain economic periods (financial system instabilities or financial crises) require government involvement or the government's final judgement. For example, this applies in regards of foreign exchange intervention or the management of government funds.

There are additional reasons why an exaggerated concentration on the role of international factors is misleading in Japan's case. First, it casts serious doubts to assume that foreign investors stopped, or were overly reluctant to invest in Japan, because of the dependent status of the BOJ before 1998. There is no data that supports the claim that international investors were reluctant to invest in the Japanese markets. Lukauskas and Shimabukuro (2006: 138) find that "significant changes in capital flows

[108] A detailed discussion of the Bank of Japan Law follows in Chapter 5.

into and out of Japan did not occur in the period before revision." That is, there was no pressing need to demonstrate the adoption of international standard to foreign investors in form of an independent central bank.

Second, Drysdale, Naito, Trewin and Wilson (1999) discuss the problems of traditionally low flows of foreign direct investments (FDI) into Japan, and how the Japanese government tried to encourage FDI. The conclusion is that the Japanese government took "more aggressive action to promote FDI into Japan, for example via tax and credit incentives", rather than through central bank reform. More importantly, an argument against the international credibility explanation for central bank reform is that fundamental issues, such as financial supervision, prudential regulation and the establishment of financial entities, areas that matter most to foreign investors, were delegated to the Financial Supervisory Agency (FSA, *Kinyû Kantoku Chô*)[109], founded in July 1998, and not to the Bank of Japan. Third, in comparison to international standards and other main central banks, the new Bank of Japan Law has articles which lack accuracy at best, and limit the Bank's independence at worst.[110] As a consequence, several politicians who had an image as 'internationalists', including Ikeda Motohisa (SDP) and Tanaka Kô (Sakigake), opposed the bill of central bank law revision in the Diet in March 1997, arguing that some articles of the draft were not compatible with international standards (Lukauskas and Shimabukuro 2006: 138-139). Scholars arguing for politicians' incentives to strengthen Japan's international credibility make the mistake of regarding the new Bank of Japan Law as completely equivalent to international standards. Forth, the effort to revise the Bank of Japan Law towards more independence in an entire extent was jeopardized during the reform process by the influence of the MOF and reform opposing politicians. A compromise agreement was the result.

To sum up, this dissertation argues against an overly important role of the credibility argument, both domestically and internationally, for central bank reform in Japan. At best, international standard influenced some of the contents of the new law after politicians decided to delegate, but the above argumentation (and the findings of

[109] In 2000, the name was changed into Financial Services Agency (in Japanese: *Kinyû Chô*)
[110] Chapter 5 provides a detailed analysis of the new Bank of Japan Law.

Chapter 5 which provide a detailed analysis of the law) demonstrate that the result of the law does not meet international best practices.

4.3.4 The Legislator's Motivation – Explaining Central Bank Reform in Japan

As discussed in the previous section, the most common delegation theories fall short to explain the choice of central bank reform in Japan. Regarding a macroeconomic reasoning, the performance of Japan's economy since the 1970s indicates that low inflation performance is based on how the central bank is embedded in the political system and not whether it is independent by statute. As a result, a number of papers have tried to go beyond the assumption of a correlation between low inflation and central bank independence as reasoning for delegation, and extended the earlier literature by adding broader political economy variables and determinants into the analysis. These papers emphasize the importance of political stability (the long-lasting LDP hegemony), the weak oppositional parties, the exceedingly autonomous behaviour and conservative views of monetary policy of government bureaucrats (Nakamura 1993: 43), and, finally, the BOJ's high technical expertise and reputation which supplied the Bank of Japan with a relative high degree of de facto independence. These factors[111] are essential indicators to explain the low inflation environment in Japan (Lohmann 1997; Cargill, Hutchison and Itô 1997: 172-187; 2000: 89-90; Fratianni et al. 1997; Walsh 1997). Another important factor was that the LDP followed a long-term view of economic policy which helped to implement low-inflation policies. Its dominance made the LDP invulnerable against the incentive to request expansionary policies before elections. Following this reasoning, inflation can be low even with a dependent central bank (Walsh 1997: 114). The above political factors demonstrate that Japan's economic and political performance with the hegemony of the leading party LDP in the centre is supportive to the argument that there is a correlation between political stability and low inflation (Cukierman, Edwards, and Tabellini 1992; Cargill, Hutchison and Itô 1997: 190-191).

In order to understand central bank reform in Japan, this thesis argues that political reasons with a concept of 'blame shifting' and a changing LDP-MOF relationship are

[111] Cargill, Hutchison and Itô (1997: 187-188) add two further aspects that led to a low inflation environment in the Japanese economy: First, the memory of the high inflation in the post-war era and the wild inflation in the 1970s, and, second, the autonomous behaviour of some central bank Governors.

the most convincing approaches to explain institutional choice and revision of the BOJ's new legislative framework.

4.3.5 A Bureaucratic Explanation: The Changing Relationship between the LDP and the MOF[112]

As seen in the previous section, the political and economic system in Japan is characterized by particular features. One notable feature is that the Japanese political environment has been characterized by a remarkable political stability since the Second World War, a stability that was based on the LDP's commitment to seek rapid economic growth. This political stability was linked with a strong relationship between the LDP and bureaucracy. Basically, the relationship between the LDP and the MOF can be distinguished into three periods:

1. The LDP dominance between 1955 and 1993
2. The change of political power between 1993 and 1994
3. The return of the LDP in 1994

The LDP dominance between 1955 and 1993

The LDP maintained a single party dominance (*jimintô tandoku seiken*) in the Japanese government between 1955 and 1993, during which LDP politicians formed a stable and close cooperation with MOF bureaucrats that was comfortable for both the LDP and MOF.[113] As a consequence, the MOF developed into the most powerful Ministry in Japan, playing a dominant role in shaping the Japanese economic system. MOF bureaucrats accumulated a high level of professional expertise, and dominated the supply of information to LDP politicians.[114] By providing information and expertise, bureaucrats were able to exert a high extent of influence on policy-making[115] [116] (Hori

[112] A thorough analysis of the LDP and MOF relationship is beyond the scope of this study. Here, only important issues regarding BOJ reform are considered. For further study of the issue, see Amyx 2004, Hori 2005; Katô 2002, Mabuchi 1997).

[113] For a critical comment of this issue, see Saitô (1996: 18) who describes the "ambiguous and opaque relationship" between MOF and LDP lawmakers and its decision-making process as undemocratic, supralegal, and self-complacent.

[114] One important reason for this is that Japanese Ministers usually do not bring own staff with them when entering a Ministry, what means that they depend to a high extent on the Ministry (Curtis 1999: 7).

[115] This situation of a long time stable partnership between the LDP and MOF was characterized by a positive-sum relationship (Curtis 2002: 6; Katô 2002).

[116] In addition, it was intrinsically difficult for politicians to control the MOF, what the relationship between the Hosokawa Cabinet (Pascha 2005a: 23) or Finance Minister Takemura (Brown 1999: 190) with the MOF illustratively showed.

2005: 133; Aoki 1988: 286-297; Muramatsu and Scheiner 2007; Curtis 1999: 60-61; 2002: 5-12; Katô 2002; Nemoto 2002: 19-20).

In stark contrast, contacts of MOF bureaucrats to politicians of the opposition were kept at minimum, important legislative matters or budgetary preferences were hardly ever discussed. The fact that the Ministry's political interactions focused on the LDP had an obvious reason. Many MOF officials had political ambitions after retirement from the Ministry. Entering the field of politics successfully made it profitable to build up deep contacts within only a single party. Therefore, personal contacts have been built and continuously developed between Ministry's officials and senior politicians in the LDP[117] (Babb 1995: 544; Brown 1999: 172-175; Curtis 1999: 62-63).

The change of political power between 1993 and 1994

The year 1993 marked a key turning point in Japanese political history. After the LDP lost the majority in the Lower House in 1993, the LDP was forced into the unprecedented situation of acting in the opposition.[118] The loss of LDP's hegemony led to a new political environment, and altered the relationship between the bureaucracy and elected officials in a significant way. As a result, the system of mutual cooperation between the LDP and the MOF was damaged. The LDP would have preferred to continue this privileged relationship, but the developments of the political environment made it no longer possible to maintain these exclusive insider networks.

The MOF also had to deal with the new political circumstances. In essence, the Ministry was confronted with three options: first, to preserve the cooperation with the LDP. Second, the MOF could collaborate with the new ruling coalition. The last option was to hold a neutral position, and hope for a quick recovery of the weakened LDP. The MOF chose the second option and decided to cooperate with the parties in power in the same way it had previously done with the LDP. This applied especially to the Japan Renewal Party (JRP, *Shinseitô*), for the MOF believed that this party would hold political power for a long time. Put differently, the Ministry chose the most suitable way to keep as much influence as possible (Mabuchi 1997: 33). This choice demonstrated that the

[117] In addition, both the majority of MOF bureaucrats and many Diet members are graduates from the prestigious Tôkyô University which increases potentially classmates' relationships.
[118] See, Curtis (1999: Chapter 3, 65-98) for a detailed review of events that led to the collapse of LDP dominance.

MOF was merely interested in keeping contact with politicians in power. MOF's decision to end the long-standing and profitable cooperation came like a blow to many LDP politicians (Toya 2006: 166). In particular, Katô, LDP Secretary General, who had longstanding ties with the Ministry, was shocked with MOF bureaucrats who started to shift their cooperation to the Hosokawa Cabinet in 1993.

Due to this development, the relationship between the LDP and bureaucrats shifted from a cooperative to a competitive relationship. The LDP's loss of power led to a fundamental change of the traditional principal-agent framework of the LDP and MOF from a positive-sum to a zero-sum relationship. Bureaucrats traditionally enjoy a competitive edge concerning information. The problem for LDP politicians was that they failed to build a structure that would enable them to act more independent from the Ministry in regards of many key policies. The resulting competitive character of the relationship to the MOF left many LDP politicians helpless (Muramatsu and Scheiner 2007).

The return of the LDP in 1994

The strategy of the MOF to shift cooperation to non-LDP parties backfired at the moment the LDP regained power in 1994, once again becoming the strongest party. However, it was impossible to rebuild the former collaboration with the MOF on its past foundation. In fact, it turned out that the LDP was unwilling to return to the previous agreement of cooperation with the MOF. Instead, having taken the former events into consideration, some LDP politicians became increasingly acrimonious, wishing to punish the MOF for its disloyalty during the LDP's short-term period out of power between 1993 and 1994. Since 1993, the relationship between the LDP and the MOF has been generated growing mutual distrust, which made it impossible to return to the previous cooperation. In addition, Curtis (2002: 11-12) argues that, although the LDP regained part of its political power in 1994, it was dependent on coalition partners forming a government. This led to a weakening of the exclusive relationship between the LDP and the bureaucracy.

Still, a large number of LDP politicians had close contacts, and supported the MOF, feeling a responsibility from previous times to act as the Ministry's guardian.[119] However, influential LDP lawmakers felt bitterness against the MOF and sought "revenge". A growing number of lawmakers thought it as beneficial to distance themselves from the MOF, increasing electoral chances by bashing the unpopular MOF. Politicians used a strategy to make the ministry a scapegoat (see next section) and decided to encourage MOF reform.[120] In other words, the willingness to sacrifice the Ministry in order to obtain credit from the electorate gained impetus among LDP lawmakers (Hiwatari 2000: 126; Mabuchi 1997: 32-36; 134-255; Hori 2005: 129-130; Brown 1999: 172-177; Grimes 2001: 202-203; Malcolm 2001: 89-97; Sasaki 2002: 102; Svensson, Mabuchi, Kamikawa 2006: 65).

This chapter demonstrated that the end of the LDP hegemony in 1993 led to a changing relationship between the LDP and the MOF opening the path for institutional reform.[121] The weakening of the cooperation between the LDP and the MOF is commonly regarded as an indispensable prerequisite for institutional reform, including the BOJ's independence (i.e. Cargill, Hutchison and Itô 2000: 92; Hori 2005; Mabuchi 1997).

The following chapter will analyse how politicians made use of the new situation treating the MOF as a scapegoat, blaming it for the severe economic conditions in Japan. The analysis is based on the concept of blame avoidance.

4.3.6 The Concept of Blame Avoidance

4.3.6.1 The Politics of Blame Avoidance

The concept of blame avoidance has been widely discussed in the literature, for example by Weaver 1986; Balla et al. 2002; Shinkawa 2005; Hood 2002; McGraw 1990. The strategy of blame avoidance is characterized by politicians' incentive to avoid

[119] For instance, Hiwatari (2000: 125-131) argues that the LDP returned to some extent to its former position as the guard for the Ministry, after gaining an electoral success in the October 1996 Lower House election.

[120] At this point, it must be noted that central bank reform in Japan cannot be viewed as a single reform, rather it was accompanied by larger administrative reform. More precisely the revision of the Bank of Japan Law was part of MOF reform, the so-called "big bang", which started in November 1996 (Nakakita 2001: 50-51; Toya 2006).

[121] Toya (2006) points out to the complex result of the changing relationship between the LDP and MOF after 1994. The relationship was characterized by three features: cooperation with the *jûsen* problem, competition with the "big bang" reform, and conflict with MOF reform and Bank of Japan Law revision.

accountability, and their strategies are limited "by concerns about the impact of unpopular measures on future election outcomes."

The concept of blame avoidance became popular in the 1990s, as economic conditions forced politicians in developed countries to make increasingly detested choices which imposed high costs on the electorate. Financial globalisation has made it increasingly challenging for governments to pursue stability and economic revitalization in times of severe recessions. This leads to selfish behaviour of office-seeking politicians. If certain policy actions will lead to high costs, lawmakers try to avoid blame for unpopular decisions and view it as beneficial to delegate.[122] In contrast, if benefits exceed costs politicians claim credit for policy decisions and remain with the status quo. In other words, politicians only delegate if expected benefits exceed the costs (Voigt and Salzberger 2002: 294-295).

Weaver (1986: 377-378) finds various determinants of blame avoidance behaviour, including the extent of risk aversion, politicians' motivation for re-election, the number of competing parties, the preferences of the voters, and how these preferences can be interpreted into political gains and losses. This approach argues that blame-avoidance is the dominant strategy of politicians seeking re-election. While not asserting that politicians never use alternative strategies, Weaver (1986: 371-372) stated unequivocally that: "Politicians are motivated primarily by the desire to avoid blame for unpopular actions rather than by seeking to claim credit for popular ones […] [M]ost officeholders seek above all not to maximize the credit they receive but to minimize blame." This can be seen as a rationale for politicians to restructure or break up bureaucratic institutions.[123] This argument assumes that voters are more sensitive towards real or potential losses than gains. Mabuchi, Kamikawa and Svensson (2006: 46) extend Weaver's approach by arguing that "the politics of blame avoidance—and the specific strategy of blame avoidance that was chosen—are shaped by institutional and perceptual constraints."

[122] For instance, Kane (1980) observes that US congressman consider it as "extremely convenient" to shift the blame to the Federal Reserve in times of economic turmoil culminating in financial distress. According to Kane the Fed's independence is low and its main, daunting function is "to deflect blame from the real policy makers".

[123] In detail, Weaver (1986) lists examples of blame avoidance behaviour by American politicians in a US-typical surrounding of a decentralized Congress and loose party discipline. He finds that the activity of blame avoidance is leading to a withdrawal of discretion.

Weaver (1986) distinguishes between eight blame avoidance strategies; one of these is the so-called scapegoat argument.[124]As already demonstrated, governments preferably delegate with the electorate unpopular, but necessary policies to international or independent agencies. The agency can enforce unpopular policies, even in cases of high resistance by the electorate. Applying this argument to central bank reform, delegation is regarded as a search of a "convenient scapegoat" or, in other words, a "strategic shirking" by politicians in order to avoid blame in difficult economic times (Semler 1994: 51). The argument is that a political party is not necessarily weakened by central bank independence, but rather could benefit from granting independence to a central bank, in order to transfer responsibility for monetary policy in difficult economic situations. For example, interest rate hikes may impose immense burdens on interest groups or the entire electorate. In such situations, lawmakers shift the blame to the (independent) central bank for unpopular, but necessary policy measures. The central bank acts as a scapegoat or "risk taker" for politicians (Alesina and Tabellini 2005: 3, 17-18; Boylan 2001: 126; Elgie 1998: 65-66; Johnson 2006: 92-98; Posen 2002; Tager 2007: 363). Some scholars applied the scapegoat argument to explain monetary policy decisions made by central banks, including the German Bundesbank (Berger 1997; Marsh 1992), the ECB (Alesina and Stella 2010; Aziz 2005: 544), or the US Federal Reserve (Kane 1980, 1990; Morris and Munger 1998: 376).

In Japan's case, the scapegoat argument is a useful tool to explain BJL revision. The concept of trying to "find a scapegoat" helps to explain the rationale behind the decision of Japanese politicians to delegate. This strategy can be useful to explain the behaviour of politicians after the discovery of past scandals and policy mistakes (Weaver 1986: 387-388).

4.3.6.2 The Blame Shifting Hypothesis in Japan

This subchapter applies the concept of blame shifting from the previous section to central bank reform in Japan. In a general sense, the political culture in Japan is particularly characterised by a concept of blame (Horiuchi 2007; Svensson, Mabuchi and Kamikawa 2006). For instance, Shinkawa (2005) analyses the pension retrenchment

[124] Applying the scapegoat argument, Kane (1982) builds a theory to explain how American politicians have tried to use the Fed as a scapegoat.

in combination with the politics of blame avoidance. Hiwatari (2000) uses the blame avoidance concept to explain the reorganisation of the financial bureaucracy, namely the liquidation of housing loan finance corporations and the creation of policies for troubled banks.

Usually, the blame avoidance approach is used to explain the behaviour between parties. However, in Japan the blame avoidance strategy can be applied differently. Politicians shifted blame to a third actor, the MOF. Politicians' strategy to attack and shift blame to the MOF was only possible, because the traditionally strong cooperation between the LDP and the MOF was damaged (see, Section 4.3.5). Japanese lawmakers have blamed bureaucrats for policy failures in a regular way, which is a common strategy. Bureaucrats accepted such responsibility receiving politicians' support in establishing new programs or institutions in return. However, in the 1990s, politicians blamed the Ministry in a much stronger way than usual (Muramatsu 2004: 29).

Why was the strategy of blaming the MOF so attractive for politicians? Apart from the desire to punish the disloyal Ministry, the economic conditions were deteriorating and disasters such as bankruptcies of financial institutions made the situation so severe that politicians needed to demonstrate activism to the public. Taking this into consideration, making MOF the scapegoat was a rational strategy or a "convenient way" for LDP politicians to avoid taking responsibility as a means to guarantee their political survival[125] (Curtis 1999: 57).

4.3.6.3 Failures and Scandals in the Ministry of Finance

In the 1990s, Japan suffered a financial crisis after the busting of the bubble economy, leading to a recession between 1991 and 1993. The collapse of the bubble economy led to a growing distrust of the public in the capability of the LDP-bureaucracy partnership to handle the economy successfully. Since 1995, things had been going worse due to a number of financial disasters further damaging the Japanese economy. Particularly the problem of *jûsen (tokutei jûtaku kinyû senmon gaisha)* seemed out of control. *Jûsen* companies were non-bank financial firms that originally specialised in providing

[125] It is interesting to note that, in this sense, BOJ reform shares some similarities with central bank reform in the UK. King (2005: 96) argues that "BoE independence was a means for New Labour to gain the electoral support of the median voter."

housing loans. In the 1970s commercial banks and security companies founded the *jûsen* with active support from the MOF. In the 1980s, the *jûsen* changed their lending activity towards real estate development loans, ending in excessive losses. Finally, many *jûsen* went bankrupt and the government issued a rescue plan to save insolvent *jûsen* in December 1995.[126] This was a very unpopular political decision among the voters, for taxpayer's money was used to cover these losses (Nakasô 2001: 6). Konoe (2009) documents the events as following:

> "The MOF was forced to ask directly for taxpayers' money. After bitter political battles between the MOF, the Ministry of Agriculture, Forestry and Fisheries (MAFF), and the Liberal Democratic Party (LDP), which was the majority party of which farmers were a large constituency, a public fund injection of 685 billion yen ($6.3 billion) was approved for the resolution of jûsen in June 1996. This caused huge public criticism of the MOF, banks and agricultural cooperatives."

Aside from the *jûsen* crisis, the Japanese economy was hit by additional problems. First, there was the non-performing-loan (NPL) problem[127] which revealed masses of newly disclosed bad loans. Second, in August 1995, the Hyogo Bank and Kizu Credit Cooperative went bankrupt, followed by the Daiwa Bank incident one month later. [128] It can be argued that all of these troubles were areas in which the MOF had direct oversight. The Ministry was considerably involved in the *jûsen* problem. In particular, one delicate detail revealed that most of the *jûsen* were operated by retired, high ranking MOF bureaucrats (Malcolm 2001: 95; Svensson, Mabuchi, and Kamikawa 2006: 64; van Rixtel 2002: 195). In addition to these financial disasters, since 1995 it came into light that a number of MOF officials were involved in a series of bribery and wining and dining scandals with major banks, further damaging the Ministry's reputation. These scandals culminated in the arrest of various senior officials, and the resignation of Finance Minister Mitsuzuka Hiroshi and Vice Finance Minister Komura Takeshi in January 1998 (Fujii 2004: 36).[129]

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[126] See, for instance Hiwatari (2000) for details of the *jûsen* problem.
[127] Calculations vary on how costly the NPL crisis was, but it is widely considered as one of the most expansive bank rescue operation in history. The NPL had risen to 6-8 per cent of GDP (Nakasô 2001: 17).
[128] In September 1995, the Daiwa Bank announced that it had acquired enormous losses of approximately $ 1.1 billion in its New York branch and the MOF failed to notify the US authorities about the situation.
[129] In April 1998, after an investigation by the MOF, 112 officials were sanctioned for accepting unwarranted entertainment. Two top officials, Nagano Atsushi (Head of securities Bureau) and Sugii Takashi (high-ranking officer of Banking Bureau) among others resigned (Takahashi 2000: 17).

All these problems caused due attention in the mass media, resulting in a fundamental loss of public trust in the financial system. The voters became uneasy about the economic situation; the government's handling of the problems, and, in particular, scandals and corruption in the MOF. The electorate was no longer convinced that the LDP could solve the economic problems in cooperation with the MOF. The result was severe public criticism of the prestigious bureaucracy, and a demand for an organisational restructuring of the MOF. The situation led to a phenomenon known as "MOF-bashing" (*ôkurashô tataki*) in literature and media.[130] MOF bashing was not a completely new phenomenon, but after the disclosure of the MOF's scandals, the vehemence of attacks was astonishing, especially for the Ministry itself[131] (Amyx 2000: 6-7; Curtis 1999: 55-58; Konoe 2009: 499-501; Malcolm 2001: 91-101; Miyao 2001: 186; Pascha 2005a: 9-10). Finally, public support for MOF reached an unprecedented all-time low in 1996 (See, for instance, Grimes 2001: 199-203 and Malcolm 2001: 89-101). According to a Nikkei opinion poll conducted on 12 March 1996, 74 per cent of the public preferred a reorganisation of the Ministry (Lukauskas and Shimabukuro 2006: 136).[132] The extent of public criticism against their institution reached a level that even within the Ministry almost everyone seemed to realize that a certain loss of power was inescapable. As a consequence, MOF bureaucrats agreed to a reduction of authority over the Bank of Japan as long as its power over financial administration (budget) would be preserved[133] (Cargill, Hutchison and Itô 2000: 93; Hiwatari 2000: 126; Hori 2005: 119-134; Mabuchi 1997: 134-255).

4.3.6.4 Blame Avoidance as a Strategy for Politicians

Elected officials from the ruling government were concerned about being punished by the voters for the fierce economic situation. Commitment to the MOF by leading LDP politicians would generate electoral vulnerability for the party. In joining the public and the media in criticising the MOF bureaucracy and calling for financial reform,

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[130] According to Grimes (2001: 200-202), the Ministry' picture in the public has changed significantly since 1995. From 1995 on the MOF was described more and more as an institution full of over-confident and self-important bureaucrats. Its status as "elite of the elite was undermined by involvement in bribery and other scandals" (Malcolm 2001: 97).

[131] Wilson (2000: 153) notes that politicians are usually tempted to bureaucracy bashing in case bureaucrats become defensive or hostile towards pressure from politicians.

[132] In addition to the above-mentioned happenings, another factor that made the MOF unpopular with the electorate was its constant pushing for an increase in the consumption rate.

[133] Toya (2006) analyses in detail why the MOF was willing to support an institutional reform that reduces their own power.

politicians basically tried to secure their parties' success. Saitô (1996: 16), a former BOJ official, argued that policymakers "pulled out their final trump card: splitting up MOF to mollify the public". Taking the public disposition into account, shifting blame to the unpopular Ministry was a rational strategy for politicians to enhance their re-election prospects (Curtis 2002: 8; Dwyer 2004; Svensson, Mabuchi and Kamikawa 2006: 64). The behaviour of Japanese lawmakers during the financial crisis in the 1990s is a striking example for the rationale employed to avoid being blamed (Hiwatari 2000: 112; 125-127; Svensson, Mabuchi, and Kamikawa 2006). The policy measures taken to stabilize and revive the economy put a high burden on taxpayers. In this difficult situation the government needed to convince the public that it was able to overcome the problems.

Politicians from the LDP had to consider the gains and losses of dissecting the MOF very carefully. One the one hand, the electorate's preference towards MOF reform was clear. Wilson (2000: 235) notes that lawmakers usually never lose votes by disparaging the bureaucracy, and this finding is applicable to Japan. However, on the other hand, the LDP still needed the MOF's cooperation and expertise in policy making, which explains why a high number of LDP politicians avoided pushing too hard towards MOF reform. Instead, they tried to limit the coalitions' demand of a comprehensive reform.

Finally, politicians shifted blame to the MOF for policy failures, such as the collapse of the *jûsen*. Arguably, the MOF, with numerous self-made scandals, was an easy target for politicians. In particular for LDP lawmakers, political opportunism was a stronger incentive than traditional strong support for the Ministry (van Rixtel 2002: 197). In general, Japanese politicians followed two strategies: First, they aimed to punish the Ministry for its disloyal behaviour. Second, they intended to blame it for past policy mistakes and transfer their own responsibility. However, it could be argued that the MOF had to take all the blame from politicians, even for situations it was not fully responsible for. More precisely, politicians sought to drive away "the attention from their own inability to handle the banking problems promptly and effectively" (van Rixtel 2002: 197).

When analysing the blame argument for central bank reform in Japan, it can be argued that instead of creating an independent Bank of Japan in order to avoid being blamed for

future monetary policy decisions, politicians delegated authority over monetary policy to the BOJ in order to blame and punish the MOF for past policy failures. This means the blame avoidance framework was used as an ex post concept rather than ex ante. Politicians have focused on the MOF and not the BOJ or monetary policy. They have not done so in order to create an independent central bank and to avoid future disputes over monetary policy, as the uncertainty argument assumes.

In this sense, many academics argue that blame shifting was an important reason for creating an independent central bank in Japan in order to make the MOF a scapegoat (Hartcher 1998; Hiwatari 2000; Lukauskas and Shimabukuro 2006; Mikuni and Murphy 2003: 49; Muramatsu and Scheiner 2007; Pascha 2005a: 21). To make this strategy possible, former events, such as a weakened MOF, and the Ministry's loss of credibility through corruption scandals, were a prerequisite for BJL revision. Cargill, Hutchison and Itô (2000: 112) commented that "the decline in the reputation and credibility of the Ministry of Finance is especially important because it provided the political conditions that made possible the independence of the Bank of Japan." In a similar vein, Grimes (2001: 204) concludes that the MOF's "failure of macroeconomic and financial policy in the 1990s presented a rationale for increased autonomy" of the BOJ.

Gilardi (2001: 15-23) offers an additional and promising concept to explain the politician's strategy that supports the findings of the concept of blame avoidance as a rationale for central bank reform in Japan. Gilardi argues that political uncertainty is a theoretically sounder explanation for independence than credibility and blame shifting. He compares the three arguments, and comes to the conclusion that "for blame shifting, independence is a sort of shield for politicians. […] However, for this shifting to be possible, the agency does not need to be really independent, but only to be believed to be so." For a credibility-based reasoning, a similar argumentation can be made. In contrast, the case is different for political uncertainty, since "politicians need independence to prevent future holders of their current political property rights to undo their policy choices." Accordingly, in order to realize the objective of eliminating uncertainty, symbolic independence is not enough, and real independence is required.

In accordance with this reasoning, this thesis demonstrated that it is most likely that the majority of Japanese politicians, at least LDP politicians, never intended to make the

BOJ de facto independent, but rather planned to increase their own influence on the Bank (see, Section 3.6.3.1). Given the assumption that the government never intended to mandate de facto independence to the Bank of Japan, Gilardi's (2001) argument is convincing. Applying this argument indicates that if blame shifting was a major reason to delegate for Japanese politicians, then the Bank of Japan does not necessarily need to be granted independence in a de facto sense. Accordingly, the result of central bank reform manifested in the new Bank of Japan Law might be similar, regardless of what the main incentive was, whether an independent central bank or a weakened MOF. However, the de facto result will be different, namely how politicians make use of and interpret the new law.

4.3.6.5 The Role of the Sakigake

As demonstrated above, Japanese politicians sought to shift the blame to the bureaucrats as a strategy for political survival, because they were facing severe economic troubles (Curtis 2002: 8; Svensson, Mabuchi and Kamikawa 2006: 64). In particular, politicians from the Sakigake argued in favour of MOF reform, and played an important role for the revision of the BJL (see, Section 3.6.3.2). This section put its focus on the role of reformist parties, such as the Sakigake, on central bank reform.

Following Shinkawa (2005: 179), the politics of delegation also imply the significance of veto points:[134] [135] He states that the "number of veto points may affect the role and power of the bureaucracy. Where there are no veto points, bureaucracy may be able to pursue their goals and interests most effectively."

During times of stable LDP majorities in the Diet, veto points could appear only within the party. More precisely, in cases of harmony between the LDP factions there are no veto points and reform movements are difficult to achieve (Immergut and Jochem 2006: 100-103). This argument emphasises the role of LDP's coalition partners for they have provided multiple veto points to the government, a condition that has increased the possibility of institutional reform such as central bank Law revision. Hiwatari (2000:

[134] Veto players are a precondition for credible delegation. There are three different types of evidence: central banks are significantly more independent in countries with (i) strong checks and balances (Moser 1999), (ii) strong bicameralism (Bernhard 1998) or (iii) multiple veto players (Hallerberg 2002).
[135] Köllner (2006) provides useful data on veto players and their respective strength in the Japanese system in comparison to other countries.

125-131) argues that the institutional design of Japan's political world requires that parties other than the LDP call for bureaucratic restructuring. A plausible explanation for the reluctant behaviour towards reform of the majority of LDP lawmakers is that the LDP was still dependent on the Ministry's expertise in dealing with difficult economic situations. Many LDP lawmakers believed that restructuring the MOF during an economic downturn would make problems worse (see, Section 4.3.5).

In a one-party dominant system, in which chances for the opposition to replace the government are most unlikely, the only possibility to be in power for smaller parties is being part of a coalitional government. Then, however, smaller parties have to share blame for potentially unpopular policies such as tax increases. In contrast to smaller parties, only the leading party can claim credit from specific interest groups for these policies. In Japan's case, a rational strategy for smaller parties is to seek the support of the strongest party, the LDP, in order to join the government. However, here again, the LDP has the advantage of being paid by interest groups for unpopular policies. One example is the protection of the agricultural sector for conducting (an exceptionally unpopular) policy measure, such as the re-financing of the *jûsen*.[136] The LDP-coalition partners, the SDP and Sakigake were in the unfavourable situation to share the blame and lose popularity with the electorate without being substituted with the credit from particular interest groups. In an attempt to solve this situation, particularly the Sakigake pressed for a split-up of the MOF in order to gain credit from the electorate. As a result, insistent calling for MOF reform was a sensible strategy to boost the party's position and reputation. As a consequence, parties aligned with the LDP to try to lighten the dilemma by pursuing alternative measures, such as the MOF partition. In short, the dissolution of the MOF "can be understood as an instance of bureaucratic restructuring, used as a partisan blame-avoidance device" (Hiwatari 2000: 126-131; Malcolm 2001: 100).

Regarding the important role of the LDP's coalition partners, in particular the Sakigake for central bank reform, LDP parliamentarian and member of the CBSG, Shiozaki, later

[136] In December 1995, the government proposed plan to save insolvent *jûsen*, what was very unpopular with the electorate. The agriculture credit cooperatives, which "in their position as largest lenders to the *jûsen*, mobilized politicians to protect their interests" (Hiwatari 2000: 114). Thus, the *jûsen* scandal revealed close connections between the LDP and the agricultural sector. Support of the agricultural sector was essential for the LDP to stay in power. As a consequence, their "public bailout was of major interest to the LDP" (van Rixtel 2002: 194-195).

stated that "this [central bank reform] was possible only because it was a three-party coalition. It would not have been possible if it was an LDP-only government" (Tahara 1998: 36-39).[137] This view is supported by Hiwatari (2000: 110) who argues that the break-up of the MOF was a compromise agreement of the LDP made with its coalition partners.[138] In other words, if LDP was the solitary ruling party institutional reform would have been most unlikely.

A theoretical approach helps to explain the reform-seeking behaviour of the Sakigake. De Figueiredo (2002) develops simple game theoretic models of politicians' structural choice[139] to insulate policy, and finds that in systems with many veto players the only proponents of insulating policy from politics are "electorally weak groups". That is, rather than pure uncertainty reasons, the level of electoral strength is the driving force behind delegation. "Weak" parties expect to be in power only a short time, and, after losing power, the chance to regain power is expected to be low. Thus, it can be argued that the Sakigake, as a small party, sought to use its time in the government efficiently, and to encourage as many reforms, including BOJ reform, as possible as long as they were part of the government.

To sum up, the emergence of the 1998 Bank of Japan Law reform was largely the result of consensus-building across political partisanship. After the consensus forming, political key actors were able to shift blame to the MOF. Finding a scapegoat as a strategy of blame avoidance was a strategy that finally led to the outcome of Bank of Japan Law revision.

4.3.7 The Concept of Ideas

There is an additional concept that explains delegation, namely the concept of ideas. The literature on ideas is voluminous. Many scholars in social science, comparative politics, political economy and international relations theory employ the concept of ideas[140] and beliefs[141] to elucidate changes in the institutional design and choices in

[137] In Toya (2006: 163).
[138] Curtis (1999: 200-203) argues that a reason of the success of the LDP-JSP-Sakigake coalition was its policy coordination focused on consultations and compromises.
[139] This model is based on Moe's (1990) concept of structural choice.
[140] Parsons (2002: 48) defines ideas as "subjective claims about descriptions of the world, causal relationships, or the normative legitimacy of certain actions."
[141] Beliefs are defined as "mental events that entail thought" (Yee 1996: 69).

policymaking (Berman 2001: 231; Campbell 2002: 21-22; Haas 1992; Jacobsen 1995: 283; Schmidt and Radaelli 2004; Yee 1996). The benefits of an ideas-based approach are that it can be applied by a wide range of disciplines, including historical institutionalism, rational choice positivism, cultural and normative studies, constructivism, and sociology, which, in turn, apply various methodologies, including quantitative analysis, game theory, historical narrative, and qualitative analysis (Berman 2001: 233; King 2005: 96-97).[142] [143]

The concept of ideas is related to so-called epistemic communities,[144] which promote ideas to political actors. An epistemic community "is a network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue area" (Haas 1992: 3). Epistemic communities seek to exert continuing influence on politicians in order to implement institutional changes. Their influence increases in periods of uncertainties or economic distresses, i.e., when politicians are pressured to find a salient solution as soon as possible. Nonetheless, epistemic communities have to take political needs into consideration in the promotion of new ideas. If lawmakers are not convinced by the new idea, they usually prefer to maintain the status quo. The ideas of epistemic communities can overcome the policy process only if political sponsors are willing to promote the new ideology (Berman 2001: 234; King 2005: 98; McNamara 1998, Parsons 2002). In this sense, proponents of the concept of ideational explanations argue that central bank independence is caused by "the active involvement of an epistemic community that influenced a key politician to adopt this reform" (King 2005: 98).

4.3.8 The Concept of Ideas in Japan

The concept of ideas is also applied by some Japanese scholars. For instance, Hamada and Noguchi (2005) emphasize the role of ideas in policy making, especially in

[142] For a survey of the literature, see Schmidt and Radaelli (2004).
[143] Although the concept of ideas is broadly regarded as one aspect among many for explaining political behaviour, both sceptics and supporters argue that the ideational literature has not gained a broader audience due to its lack of a comprehensive research design and precise specification (Berman 2001: 231; Schmidt and Radaelli 2004; Yee 1996: 69-70).
[144] The term epistemic community has been defined in various ways. Basically, epistemic communities are a certain set of people, i.e. scientific communities or professionals. Epistemic communities can also be organisations, such as IMF, OECD, BIS, or G 7, and in a wider range it includes i.e. a group of academics. A similar definition suggests that epistemic communities are "a sociological group with a common style of thinking" (Haas 1992: 3, note 4). See, Haas (1992: 3) for a summary and further explanation of the term.

macroeconomic issues. Hamada and Noguchi present two examples in which "wrong" ideas negatively influenced policy decision-making in Japan. Regarding deflation, for instance, the public was misguided that deflation is beneficial for the Japanese economy.[145] The authors argue that this "erroneous thinking" was widely supported by the mass media, prolonging the recession of the Japanese economy since the 1990s.

Arguably, it is far-fetched to claim that the concept of ideas is an essential model of delegation to an independent Bank of Japan. However, some aspects deserve attention. For instance, McNamara's three-stage model (1998) underlines the importance of the activity of individuals (for instance, politicians or academics) rather than groups, such as partisan or the financial sector, in explaining central bank reform.[146] In other words, this concept helps to explain why lawmakers from different parties, such as Katô and Shiozaki from the LDP, Itô from the SDP and Chair of the Project Team, and politicians from the Sakigake supported BOJ independence. Kanegae (1999: 17) argues that certain academics had promoted central bank independence in Japan at an earlier point in time.[147] However, the idea of central bank independence found little support in political circles until 1996. However, in 1996, the situation changed regarding politicians' willingness to reform the obsolete Bank of Japan Law. Ideas dealing with central bank independence became important, for instance, from institutions, the Research group of financial system of the Japan Society for Monetary Economics (JSME)[148] and academics including Kanegae (1995), Mikitani (1996, 1997), and Aizawa (1995). According to the concept of ideas, the existence of Japanese economists and academics that were eager to convince and advise politicians is another crucial point. Professor Mikitani Ryoichi of Kobe University and member of the JSME was one person who fiercely promoted central bank reform. He gave a speech in which he argued for central bank independence in the Upper House.

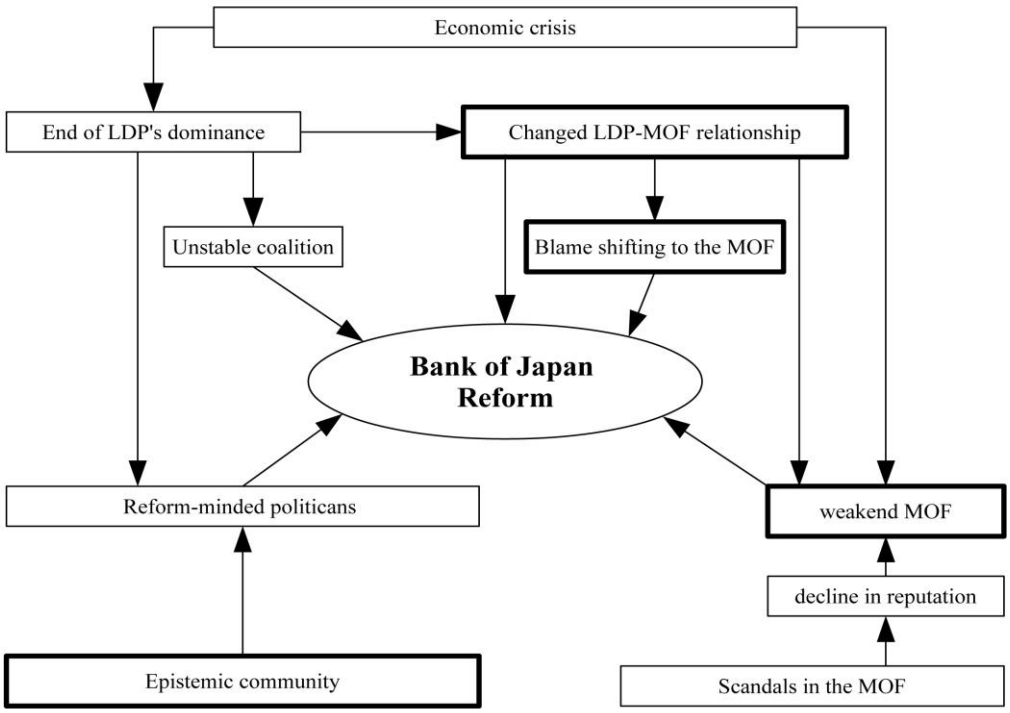
[145] Hamada and Noguchi (2005: 3) list some statements that stand for a positive attitude towards deflation, for instance, "deflation is not a monetary problem", "deflation should be remedied not by monetary policy but by government expenditure policy", and "deflation originated from technological innovations and from inexpensive imports is a blessing".
[146] For instance, King (2005) applies McNamara's model to explain central bank reform in the United Kingdom.
[147] See, e.g. Yoshino (1962), Saitô (1988), Suzuki (1993), and Kanegae (1995).
[148] Kanegae (1999: iv-v)

4.3.9 Central Bank Reform in Japan

The major incentive of Bank of Japan Law revision was to weaken the power of the MOF (Oritani 2010: 16). Thus, because of the linkage of MOF reform and the political changes, certain scholars find that the Bank of Japan Law revision came to some extent by "windfall" (*tana kara botamochi*) (Yamawaki 2002: 103), characterizing it as a "coincidental" reform (Volz and Fujimura 2008: 6). Figure 4-1 summarizes the findings of this chapter and the circumstances that led to central bank reform in Japan. Scandals and crises of the MOF had deepened the mistrust in the bureaucracy, and helped to generate support for the concept of an independent central bank, amongst the general public, the media and politicians. This coincides with McNamara's (2002) argument that crises open the door for institutional changes. That is the reason why many scholars argue that the independence of the new Bank of Japan was not something the BOJ had successfully fought for and won (*kachitotta*), rather reform came by default, arriving as a consequence of the failures and scandals (*tekishitsu*) of the MOF (Fujii 2004: 268; Mabuchi 1997: 62; Nakakita 2001: 50, 58; Yamawaki 2002: 265). Mikitani and Kuwayama (1998: 2) conclude that "the successful effort to enact a new [BOJ] law gained its impetus from failure."

In order to implement central bank reform, fundamental changes in the political-bureaucratic environment, such as the loss of power of the LDP and the changing relationship between the LDP and the MOF, were necessary. The findings of this thesis argue that blame shifting was an important reason for Japanese politicians to revise the BOJ Law. Making the MOF a scapegoat for the economic distress in the 1990s was a rational blame avoidance strategy used by lawmakers to survive the impending election. The concept of blame avoidance in combination with fundamental changes in the political-bureaucratic environment, such as the loss of power of the LDP and the changing relationship LDP and MOF, provide a sound explanation for central bank reform in Japan. Another factor were key actors who promoted the idea of central bank reform (e.g. Yoshino, Mikitani, Kanegae) to politicians who were supportive of the idea of central bank independence (Politicians from the Sakigake or Shiozaki), or at least, who saw the necessity for a fundamental change in order to secure re-election prospects, because of an unstable tripartite ruling coalition. It can be also argued that BOJ reform was forced from beginning to end by politicians, which is a rare phenomenon for a financial market reform.

Figure 4-1: Bank of Japan Reform



Source: Own illustration

4.4 Conclusion

This chapter reviewed the existing literature on delegation to an independent central bank and tested the most relevant theories on the Bank of Japan. In addition, this chapter demonstrated that central bank reform in Japan cannot be explained by a single delegation theory, but rather has multifaceted reasons. In Japan's case, many of the common delegation theories do not work. Rather, this thesis attributed the motive to decidedly political factors. Extraordinary political events and bureaucratic scandals led to high uncertainty among the electorate. The collapse of LDP hegemony in 1993 is regarded as a landmark event that led to a changing relationship between the LDP and MOF. This thesis identifies the resulting modified relationship as an important factor for financial reform, including the revision of the Bank of Japan Law. The examination of the Bank of Japan Law revision process demonstrates that "selfish politico-economic reasons" played a key role (Pascha 2005a: 9). The most important motive for the ruling

parties in the Hashimoto Cabinet to support reform was the struggle for political survival, namely their attempt to survive the forthcoming election.

5. THE BANK OF JAPAN AND CENTRAL BANK INDEPENDENCE (DE IURE ANALYSIS)

This chapter provides a detailed analysis of the Bank of Japan's de iure central bank independence by analysing the new Bank of Japan Law. Section 5.1 provides definitions of the term central bank independence. Section 5.2 draws attention to the Bank of Japan and its de iure status (BOJ Law), and is structured as follows. Section 5.2.1 starts with a description of the Bank of Japan Act from 1942, followed by a detailed investigation of the 1998 Bank of Japan Law in section 5.2.2. The foci of the analyses are a summary of the most essential contents, and the examination of the most significant features of central bank independence. On the basis of this discussion, this section demonstrates that the Bank of Japan Law includes various weaknesses regarding independence (Section 5.3). One important strand of literature about central bank independence focuses on the measurement of central bank independence. Section 5.4 provides an introduction of the most important indices, discusses the problems and difficulties, and summarizes the results concerning the Bank of Japan. Section 5.5 provides a conclusion.

5.1 Central Bank Independence

5.1.1 Introduction

As previously stated, many governments have granted legal independence to their central banks. Legal independence means that the central bank is able to conduct monetary policy without explicit or implicit pressure from the government. This section guides through the analysis of different categories of central bank independence and aims to draw conclusions for the Bank of Japan.

Due to its complexity, it is necessary to analyse the term 'central bank independence' in more detail. Starting with a general definition, according to the Webster's New Universal Unabridged Dictionary, 2nd edition, the term independent is defined as: "…not subject to the control, influence, or determination of another or others…not depending on another for financial support…". One line of research considers central bank independence as the degree of influence which the government or politicians can (legally) exert on the central bank. This means a central bank acts independently if it conducts monetary policy without pressure and interventions of the government. Bell (2001: 459), for instance, defines central bank independence as "the institutional

capacity – typically derived from an institutional mandate, with the support of government – to conduct monetary policy free from significant government input or meddling". Similarly, Capie et al. (1994: 50) views central bank independence as "the right to change the key operational instrument without consultation or challenge from government."

Bernhard (2002: 21-22) identifies three formal characteristics of central bank independence. First, the control of monetary policy instruments (Debelle and Fischer 1994; Fischer 1995). A second aspect that determines the central bank's independence is the appointment process of its key positions. The key question is to what extent the Cabinet is able to select the composition of the bank's monetary policy decision-making body. Is the Cabinet alone or are there other parties, such as the legislature or commercial banks that build the central bank's governing members? Another related issue is the length of the terms of the key staff. The third element of central bank independence refers to the Cabinet's power to formulate ex-post sanctions, including oversight (Bawn 1997; Lupia and McCubbins 1994; McCubbins and Schwartz 1984), replacements of the staff (Keefer and Stasavage 2003; Lohmann 1992), and policy veto points (Ferejohn and Shipan 1990; Segal 1994). Putting all arguments together, central bank independence "reflects the bank's ability to control monetary instruments, restrictions on the Cabinet's influence over the appointment procedure, and limitations on the Cabinet's ability to punish the central bank" (Bernhard 2002: 21). In a subsequent step, it is necessary to distinguish between different kinds of independence to gain a deeper understanding of the issue of central bank independence, which will be investigated in the following sections.

5.1.2 Definition of Central Bank Independence

5.1.2.1 Goal Independence

Certain scholars divide central bank independence into two aspects: goal and instrument independence (Debelle and Fischer 1994; Fischer 1995; Walsh 1995). According to Debelle and Fischer (1994: 197), a goal independent central bank is characterized by an independent setting of the final goals of monetary policy, i.e., the central bank can decide whether it concentrates on price stability, growth rate, or unemployment.[149]

[149] Sibert (2009) notes that among the major central banks only the ECB has an unusual high amount of goal independence. However, the U.S. Federal Reserve is also commonly regarded as goal independent

Bofinger et al. (2001: 209) provides a similar definition: "A central bank enjoys goal independence when it is free to choose its goals or at least free to decide the actual target values for a given goal." However, a clear definition of the goals of monetary policy should include both the choice between price stability and nominal GDP, and a precise description of the time horizon for their achievement and numerical target values. As a consequence, goal independence can have various interpretations, and has in reality many different forms (Bofinger et al. 2001: 209-210). Arguments, which speak for goal independent central banks, can be summarized as follows (Goodhart 2000: 227-228):

1. A monetary target set by the government may reduce credibility
2. A government-set target may decrease the discretionary powers of central banks, particularly in the case of an adverse supply shock
3. The last argument has to do with empirics. Two of the most successful central banks in the world, the US Federal Reserve and the Bundesbank, never had to follow an explicit target set by the government. It is doubtful if they could have been so successful without a special kind of institutional framework

An additional advantage is that goal independence shields the central bank from too much political pressure. This, however, comes at the costs of democratic accountability (Baltensberger et al. 2007: 90). Economic literature identifies the following arguments against the implementation of goal independence (Goodhart 2000: 227-228):

1. The central bank's key staff is not elected by the public. A high degree of power of a central bank may trigger the problem of a democratic deficit
2. If the government is responsible for setting the objective, an effective coordination between the government and the central bank is more probable
3. A government-set explicit and quantified target is an essential factor for transparency and accountability. In the case of multiple objectives or imprecisely formulated targets, it is difficult to hold the central bank

(e.g. Belke and Polleit 2009: 528). Mishkin (2007: 321) views the Fed as both instrument and goal independent.

accountable, which means that transparency is reduced. To avoid this problem, a government-set target may be helpful

As a consequence, making central banks goal independent is criticised by some scholars (for instance, Blinder 1998). Bernanke et al. (1999: 312) conclude that "[b]ecause ultimately policy objectives in a democracy must reflect the popular will, they should be set by elected officials".

5.1.2.2 Instrument Independence

The other concept is instrument independence. Instrument independence refers to the central bank's authority to choose every monetary policy instrument it views as adequate without governmental interference (Lybek and Morris 2004: 11), i.e., an instrument independent central bank can choose its means to realize its operating targets without restraint (Debelle and Fischer 1994: 197). According to Bofinger et al. (2001: 213), instrument independence is characterized by three essential features: the control of the short-term interest rate as the key element of monetary policy, the control of the exchange rate as a supplementary target, and limitations of central bank credits to the government.

In comparison to the discussion of goal independence, the vast majority of economists agree upon the necessity instrument independent central banks (e.g. Amato und Gerlach 2002; Fischer 1995; Mishkin 2004b). Indeed, in most cases the central bank statutes allow the central bank to determine interest rates independently. As a result of the goal and instrument independence debate, Fischer (1995: 202) concludes that "[t]he most important conclusion of both theoretical and empirical literatures is that a central bank should have instrument independence, but should not have goal independence." To implement the goals fixed by the government, central banks should have independence both from government and financial markets.

5.1.3 Central Bank Independence: Another Concept

However, in order to gain a more extensive understanding of central bank independence one has to distinguish between additional categories. In a more detailed approach, academics differentiate between the following categories of central bank independence:

1. Institutional and legal independence
2. Personal independence
3. Functional and operational independence
4. Financial and organisational independence

Institutional and Legal Independence

According to Bebenroth and Vollmer (2007: 45), "a central bank is institutionally independent if its status is enshrined in central bank law." Institutional independence is one key aspect of central bank independence, and the absence of government intervention in central bank decision-making processes should be mentioned in a central bank's statute. Generally, "it is widely accepted that institutional features aimed at granting legal independence to the central bank must ensure its undisputed authority to fulfil a clear monetary policy mandate" (Martinez-Resano 2004: 7). Legal independence is formally derived from the central bank law or statute, and "concerns its prescribed relationship to the central government" (Marcussen 2005: 907). In most countries, "central bank independence is not a constitutional requirement but rather determined by a legislative statute, the legal independence of the central bank is granted by a majority vote of the legislators and can be removed by the same decision rule" (Moser 1999: 1571). However, one has to be careful, for a central bank's legal independence can be very different from its de facto independence.[150]

Personal Independence

Personal independence refers to the role, status and composition of the supreme management bodies of the central bank. It answers the question whether or under which conditions the central bank's key staff can be dismissed by the government,[151] the length of the mandate, and the procedure of appointment with possible renewals of Policy Board members. It is considered supportive for personal independence if the term of office is non-renewable (Bofinger et al. 2001: 215-216; Negrea and Munteanu 2008: 517).

[150] This will be shown in a following section about central bank indices.
[151] In case of the Reserve Bank of New Zealand, the governing body only consists of one person, the Governor. This fact is especially prone to partisan appointments of the government (Bofinger et al. 2001: 215).

Functional and Operational Independence

The issue of functional and operational independence has already been widely discussed in literature on central banks due to their influence on monetary policy decision making. Functional and operational independence is also referred to as political independence (Negrea and Munteanu 2008: 518). Operational independence is understood as having extensive discretionary powers to effectively conduct monetary policy objectives. Operational independence basically requires independent interest rate setting (Martinez-Resano 2004: 7).

Financial and Organisational Independence

In comparison to other issues regarding central bank independence, the subject of financial independence is relatively scarce in literature. However, this does not mean that financial independence is unimportant. In fact, "financial independence aspirations occupy a prominent role in most central bank's statutes". Financially independent central banks are provided with "sufficient resources to attain its fundamental policy objections" and with "the adequate balance sheet structure to efficiently perform its functions". However, the definition of the term is deliberately wide-ranging in order to deal with the multifaceted structure of central banks in the real world (Martinez-Resano 2004: 6-8). In addition, according to Negrea and Munteanu (2008: 518), financial independence requires the partition of government funds from those of the central bank. In fact, "central bank functions are inevitably deployed on its balance sheet and have effects on its income statement. A financially independent central bank exhibits the adequate balance sheet structure […] to efficiently perform its functions". The institutional device of a central bank's independence should be constructed in a way that vulnerabilities are minimized, for instance, through adequate capitalization (Martinez-Resano 2004: 6-8). Simplifying the issue of financial and organisational independence a great deal, the central bank should be able to finance its expenditures without being dependent on the government's budget, i.e. "the central bank should be able to finance its expenditures out of current profits" (Belke and Polleit 2009: 528-529).

On the basis of these definitions, the following section will focus on the analysis of central bank independence of the Bank of Japan according to the new Bank of Japan Law.

5.2 The Bank of Japan Law

5.2.1 The Bank of Japan Law of 1942

The contents of the Bank of Japan Law of 1942 were interpreted as critical by many academics. This law was enacted under heavy influence of the National General Mobilization Law and served national purposes (Fujiki 2001: 76). For instance, former Executive Director of the BOJ Suzuki Yoshio (1994: 86)[152] characterized the Bank of Japan Law as "outdated and vague" and "based on fascist ideology and wartime conditions". The following subchapters will briefly investigate the main issues of the 1942 Bank of Japan Law.[153]

5.2.1.1 The Bank of Japan's Objectives

In regards of standard central bank's objectives, the Bank of Japan Law of 1942 had no special clause regarding financial stability or price stability. Instead, the Bank of Japan Law stressed that the central bank should support the national policy (Article 1),[154] and contribute to national targets (Article 2).[155] In other words, the BOJ's central role was to support the government and this law was implemented to finance the war economy.

5.2.1.2 The Policy Board

In 1949, the Bank of Japan Law was supplemented with the implementation of a Policy Board which acted as the supreme policy-making body of the Bank.[156] The Policy Board was composed of seven members. Five members had voting privileges, namely the Bank's Governor and four members, each with expertise from four business sectors: city banking, regional banking[157], commerce and industry and agriculture. However, in practice, the experts from industry and commerce and agriculture were repeatedly filled with retired officials from the Ministry of Agriculture, Forestry, and Fishery, and the Ministry of International Trade and Industry respectively (Iwata 1994: 148; Nakao and

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[152] Quoted from van Rixtel (2002: 198, note 16).

[153] For comprehensive characteristics of the Bank of Japan Law from 1942 see Kanegae (1995). Furthermore, Kanegae (1995: 101-110 and 144-147) carries out a detailed comparison between the Bank of Japan Law from 1942 with the German Reichsbank Law, the Law of the Deutsche Bundesbank (1957), and the US Federal Reserve System.

[154] "The Bank of Japan has for its object the regulation of the currency, the control and facilitation of credit and finance, and the maintenance and fostering of the credit system, pursuant to the national policy, in order that the general economic activities of the nation might adequately be enhanced". (BJL, Article 1)

[155] "The Bank of Japan shall be managed solely for achievement of national aims" (BJL, Article 2)

[156] See, Chapter 3 of this thesis (delegation).

[157] Yamawaki (2002: 83) notes that the representative from regional banks often was a former BOJ official.

Horii 1991: 27-28; Yamawaki 2002: 60-66). The additional two Policy Board members were government representatives, one from the Ministry of Finance and one from the Economic Planning Agency (EPA). These two representatives had no voting privileges, rather they facilitated the "communication and consultation between the government and the Bank" (Nakao and Horii 1991: 27; Henning 1994: 69-70).

All five eligible to vote were appointed by the Cabinet and approved by the Diet. The Governor served a five-year term and the other Policy Board members served four-year terms respectively.[158] The two government representatives served non-fixed terms (Cargill, Hutchison and Itô 1997: 182). The Policy Board customarily assembled twice a week. The voting members of the Policy Board chose the chairman, although it was customarily the Governor (Miller 1996: 6; Nakao and Horii 1991: 27-28). The Minister of Finance was provided with special "override provisions", which made the Ministry "the ultimate power" over monetary policy (Capie et al. 1994: 169). Cargill, Hutchison and Itô (2000: 89) criticised that the Policy Board with its new implemented authority missed a promising opportunity to enhance the independence of the Bank of Japan as it was legally the supreme body of monetary policymaking. Instead, the Board preferred to follow the policy recommendations of the Executive Board or the MOF. As a result, the BOJ's Policy Board was frequently referred to as the "sleeping board" (*nemureru iinkai*[159] or *kyûmin iinkai*) or "silent board" (van Rixtel 2002; Fujii 2004: 16-17; Fujiki 2004: 53; Kamikawa 2006: 132-133; Kawakita 1995: 47-50; Arita 2007: 16; Iwata 2009: 26; Yamawaki 2002: 60-66; 75-78; Fujiwara 2003).[160] [161] Fujiwara, one Deputy Governor of the new BOJ, called the meetings of the Policy Board "a ceremonial occasion" and a "joke" (Interview, Business Week, 12 June 2000).

[158] Except for obvious reasons such as physical or mental incapacity Board members could not be dismissed (Nakao and Horii 1991: 27-28). In exception, the MOF in agreement with the Cabinet dismissed Governor Yûki Toyotarô in 1944 (Henning 1994: 73-74).
[159] Iwata (2009: 26) argues that the term "*nemureru iinkai*" came from the fact that the Board did not include any monetary experts, for instance, from the BOJ`s Planning Department.
[160] For a more detailed analysis of the origin and working of the Policy Board, see Yamawaki 2002, Chapter 2.
[161] However, Kamikawa (2006: 133) argues that this practice "enhanced rather than undermined the independence of the Bank of Japan that the executive board of directors which was composed of the officials of the Bank but one Finance Ministry official who was transferred temporarily had the real power."

5.2.1.3 The Executive Board

Within the BOJ, the most important monetary policy decisions were discussed and decided by the Executive Board in the so-called round table meetings (*marutaku*). (Iwata 1994: 148; Yamawaki 2002: 65).[162] Toya (2006: 127) states that the BOJ's monetary policy decisions were made de facto by the Executive Board in consultation with the MOF. The MOF's strong influence on monetary policy decision-making was an issue of strong criticism (e.g. Mabuchi 1997). The Executive Committee met on every business day except Wednesdays. The frequent meetings were a useful measure to build up consensus on monetary policy decisions, for instance discount rate changes, call money rate, and targets for monetary growth (Kawakita 1995: 34-53; Yamawaki 2002: 76).

The Executive Board consisted of the Governor, Deputy Governor and seven BOJ Executive Directors. The BOJ executives consisted of the Senior Deputy Governor (five year term), the Deputy Governor for International Relations (four year term), and the incumbent Executive Directors of the Bank (four year term). Traditionally, one Executive Director of the BOJ was a former MOF bureaucrat (*amakudari*). However, the MOF-affiliated Executive Director never had direct responsibility over any monetary policy-making department.[163] The Senior Deputy was appointed by the Cabinet and the Deputy Governor for International Relations and the Executive Directors were appointed by the Finance Minister based on recommendations made by the BOJ. The appointment of Executive Directors was not subject to the approval of the Diet (Iwata 1994: 148; Kawakita 1995: 34; Miller 1996: 7; Nakao and Horii 1991: 27-28; Suzuki 1992: 167; Yamawaki 2002: 76).

5.2.1.4 The Responsibilities of the Bank of the Japan

The BOJ was provided with the power to carry out a high extent of central bank operations, for instance, it was able to set the official discount rate (Article 20 and 21) and the reserve requirements. Furthermore, the law ensured the Bank full discretion over open-market operations. However, in reality, changes of the discount rate or the reserve requirements needed the approval of the Finance Minister. Iwata (1994: 150)

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[162] The formal notation of the Executive Board is *yakuin shûkai* meaning "executive director's meeting".
[163] Henning (1994: 73, note 27) observes that the MOF-based executive director's responsibility has been traditionally restricted to government bond auctions and related subjects.

considers decisions over the change of the discount rate as "too politicized" between the BOJ, MOF, Prime Ministers and party leaders of the LDP. To be precise, the responsibilities of the Bank of Japan were fundamentally limited by wide-ranging powers and control mechanisms of the government and MOF. The BJL of 1942 had no clear clause regarding bank supervision and on-site examinations of private banks. Article 1 of the Bank of Japan Law requested the BOJ maintain a safe and sound financial system, and, as a consequence, the BOJ should have responsibilities to provide payment services, to monitor and supervise private financial institutions and to serve as a lender of the last resort. In reality, however, although both the MOF and the BOJ supervised private banks, the BOJ only signed contracts with banks which opened an account at the central bank (van Rixtel 2002: 132-133).

5.2.1.5 The Accountability and Transparency of the Bank of Japan

On the basis of the 1942 Law, the BOJ clearly lacked significant requirements for accountability and transparency. The sole obligation that had some references to a central bank's accountability is Article 41, which claimed that the BOJ "shall make public a statement of the general condition of the operation of the Bank for each business period in accordance with the prescriptions of the competent minister". This clause is a requirement to provide information, such as statistics and special reports about the Bank's operations, and an annual report.

5.2.1.6 The Relationship with the Government

Regarding the financing of the government,[164] the Bank of Japan Law of 1942 sets no limit on the extension of credit to the government. Rather, the Bank is obliged to supply uncollateralized loans to the government on request (Article 22 and 23), and to "undertake such businesses as are necessary for the maintenance and fostering of the credit system" (Article 25). On the other hand, the Finance Law of 1947 does not permit the BOJ to underwrite government bonds and extend loans to the government with a maturity higher than one year, unless these bonds are issued to refinance maturing debt. In this case, the Diet must authorize the required amount.[165] In addition, the BOJ may

[164] Certain scholars consider central banks as 'semi-governmental' organisations. However, according to van Rixtel (2002: 178, note 5), the BOJ is not a government organisation.
[165] In practice, during the period of 1973 and 1988 the government suffered relatively high budget deficits and the BOJ extended its operations and bought government bonds to refinance government debt (Henning 1994: 74-75).

supply credit in form of underwriting bills for short-term government finance (Henning 1994: 74-75). However, aside from financing the government the Bank of Japan Law provided the government with other wide-ranging powers over the BOJ, but also general control rights (Article 42), government authorization rights (Articles 31 and 39), business instruction rights (Article 43 and 45), the authority to dismiss the Governor (Article 47) (Nakakita 2001: 49).

The Relationship between the BOJ and MOF

The Ministry of Finance was provided with wide-ranging powers over most important subjects of the Japanese economy. Taxes were controlled by the National Tax Agency (Kokuzei chô), an affiliated agency of the MOF, the government budget via the MOF's budget bureau, foreign exchange intervention and international capital flow via the international finance bureau, government bond issue through the finance bureau, and the banking sector via the banking bureau. In all its responsibilities and powers, the MOF was highly connected with the political world. Cargill, Hutchison and Itô (1997: 190) stress the close interaction of Japanese bureaucracy with politics also in regard of monetary policy:

> "The Ministry of Finance and the LDP (until 1993, at least) had generally assumed responsibility for monetary policy and its inflationary consequences. The government agencies, viewed in their entirety, took responsibility for economic policy, and the government agencies were closely identified with the LDP."

This means that the Ministry of Finance had wide-ranging power over the Bank of Japan. Legally, the Bank of Japan Law of 1942 left the Bank under the direct control of the MOF in nearly every essential matter. Good examples are Article 42 which states that the Ministry had supervisory power over the Bank or Article 43 which states that the MOF could order "[…] the Bank to undertake any necessary business, or order alternatives in the By-Laws as well as other necessary actions". In addition, the MOF had "major oversight responsibility of BOJ operations and staffing". For instance, the MOF's permission was necessary if the Bank planned to establish branches, additional officers, or secure agents (Article 44). The Bank's main officials, the Governor, Vice Governor, Executive Directors, Auditors, and Advisors "were either appointed by, or subject to approval by the Minister [of Finance]" (Article 16). The amount of bank note

issue was decided by the Cabinet, and note issues in excess of this amount had to be approved by the MOF (Article 30 and 31) (Henning 1994: 75; Miller 1996).

Furthermore, the Finance Minister's power over Bank of Japan operations was broadened to the private sector. The Minister "[…] whenever deemed necessary […] [could] order banks or other financial institutions to cooperate in the execution of the business of the Bank of Japan" (Article 28). The approval of the Finance Minister was necessary for almost all important operations of the BOJ (Kawakita 1995: 64-67). In general, regarding central bank independence, the "old" Bank of Japan can be considered as one of the most dependent central banks in the world (see, Section 5.4.3.1). The Ministry had the power to issue directives to conduct or to refrain from certain policy measures, to dismiss members of the Policy and the Executive Board, to force the Bank to lend money to the government, and to deny the Bank's budget requests. To sum up, the Bank of Japan Law of 1942 did not contain any clauses concerning the Bank's actual independency. Instead, the legal status limited the BOJ's role to an agent of the Ministry of Finance.

5.2.1.7 Foreign Exchange Rate Interventions

The Finance Minister was empowered in deciding Japan's exchange rate policy. The Foreign Exchange Fund Special Account Law of 1951 provided the legal framework for foreign exchange rate interventions. The Foreign Exchange Funds Special Account (FEFSA) issues short-term securities to gain Yen funds in order to finance foreign exchange capital; these Yen funds are purchased by the Bank of Japan or other governmental organisations (OECD 1972: 24). Articles 1, 5, and 6 of the BJL of 1942 provided the Finance Minister with the power to direct the BOJ in purchasing and selling foreign exchange. The budget of the special account was arranged by the Cabinet and needed the approval of the Diet. However, the Bank could independently conduct open market operations, and, therefore, had the power to sterilize foreign exchange interventions on domestic money markets (Henning 1994: 80-82). In the following section, the focus will shift to the new Bank of Japan Law and anlyse the Bank of Japan's independence in detail.

5.2.2 The Bank of Japan Law of 1998

This section examines the most important subjects of the newly revised Bank of Japan Law from 1998.[166] The Bank of Japan Act (Act No. 89) is structured in ten chapters:

Chapter I: General Provisions (Article 1-13)
Chapter II: The Policy Board (Article 14-20)
Chapter III: Executives and Staff (Article 21-32)
Chapter IV: Business (Article 33-45)
Chapter V: Bank of Japan Notes (Article 46-49)
Chapter VI: Accounting (Article 50-53)
Chapter VII: Reporting to the Diet (Article 54-55)
Chapter VIII: Rectification of Illegal Actions (Article 56-58)
Chapter IX: Miscellaneous Provisions (Article 59-62)
Chapter X: Penal Provisions (Article 63-66)

Based on the Bank of Japan Act, this section will discuss the most important aspects of the new BJL regarding central bank independence.

5.2.2.1 The Bank of Japan's Objectives

The new BOJ Law provides the BOJ with two operating principles in implementing currency and monetary control. First, there is the "pursuit of price stability" (*bukka no antei*) which aims to contribute "to the sound development of the national economy" (*kokumin keizai no kenzen na hatten ni shi suru*) (Article 2). The second goal is the "maintenance of an orderly financial system" (*shikin kessai no enkatsu…shinyô chitsujo no iji*) (Article 1, Paragraph 2).

5.2.2.2 The Policy Board

The 1998 Bank of Japan Law revision confirmed the position of the Policy Board as supreme decision-making body (*saikô ishi kettei kikan*), which sets the fundamental direction of monetary policy operations, whereas the Executive Board, which had the de

[166] In some cases it will be referred to the old law. However, an explicit comparison between the pre-1998 and new law will not be conducted. For a detailed comparison, see, i.e., Tatewaki 1998: 77-118).

facto power over monetary policy, was abolished.[167] The Policy Board's powers relating to currency and monetary control are formulated in Article 15 of the BJL. The composition of the Board was fundamentally modified in the new law. According to the new law, the Board should consist of nine members: the Governor, two Deputy Governors[168] and six "deliberative members" (Article 16, Paragraph 2). The deliberative members should be "experts on the economy or finance", or have "academic expertise or experience" (Article 23, Paragraph 2). All Policy Board members are appointed by the Cabinet and need the approval of the Diet, both the Lower and the Upper House. The enhanced size of the Policy Board was viewed to guarantee a broader view about monetary policy, since they do not represent financial institutions, agriculture, or commerce (Cargill, Hutchison and Itô 2000: 102; Ôshima and Ide 2006: 12).

However, two government representatives (the Minister of Finance and the Minister of the Economic Planning Agency, respectively their representatives) can attend Board meetings (Article 19). Although they have no voting rights in monetary policy decisions, they can express views, submit proposals and even request a postponement of a monetary policy decision until the next Board meeting (Article 19, Paragraph 2).[169] However, the Bank can reject the request made by the government representatives (Article 19, Paragraph 3). Regardless of the rejection provision, the two government representatives are a limiting factor for the central bank's independence.[170]

In comparison to the 1942 Bank of Japan Law, the government lost its previous formal representation in the BOJ's Monetary Policy Board. However, the former practice of filling the Policy Board regularly with former Government officials (see, section 5.2.1.2) was re-installed with the appointment of Mutô and Iwata in 2003 (see, section 8.5.2). Yamawaki (2002: 85) argues that the presence of the government has changed.

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[167] One BOJ executive stated that the power "was given back to the Policy Board from the Executive Board" (*shikkô bu kara seisaku iinkai ni taisei hôkan sareta*) (Nikkei, 8 May 1998).
[168] There were critical voices of the concept of two Deputy Governors (see, e.g. Nakahara 2006: 268-269).
[169] The right to postpone a vote was anchored in other central bank laws as well, for example in the Deutsche Bundesbank Law. The government had the right to postpone decisions up to two weeks. However, due to requirements for the currency union this article was abandoned in December, 22, 1997 (Botzenhardt 2001: 49, note 113).
[170] Fujiwara (2003a) illustrates the procedure of a BOJ Monetary Policy Board Meeting and the role of the government representatives. They express views of the government and doing requests on behalf of the government. The publications of the transcripts (gijiroku) give detailed descriptions of the government representatives' influence (after ten years the BOJ publishes complete transcripts of Monetary Policy Board Meetings).

Under the old law, the two government members came from a government office (*yakusho jinji*), whereas now one representative is from the MOF and the other from the Economic Planning Agency (since 2002 from the Cabinet Office). Table 5-1 summarizes the main features of the BOJ's Policy Board, and provides a rough comparison with other major central banks.

Table 5-1: Comparison of the Monetary Policy Decision-Making Body of the Old and New BOJ with the ECB and the US Federal Reserve

	BOJ 1942	BOJ 1998	ECB	US Federal Reserve
Supreme decision making body	Policy Board (since 1949)	Policy Board	Governing Council	Federal Open Market Committee
Size of voting members	5	9	24 (6 Executive Board; 18 NCB Governors)	12 (7 Board of Governors + 5 Reserve Bank (RB) Presidents
Highest member	Governor	Governor	President	Chairman
Term of office	Governor 5 yrs; others 4 yrs	All 5 yrs (Possibility of re-appointment)	8 yrs (ECB Governor and Vice Governor); > 5 yrs (Central Bank Governors)	4 yrs (Chairman and Vice Chairman) 14 yrs (Board of Governors); 5 yrs (RB Presidents)
Appointment	Nomination by Cabinet. Approval of Diet is required	Same	6 members of the Executive Board are appointed by common accord of the Heads of State or Govt of the euro area countries. The Governors of the euro area central banks are appointed according to national central bank laws.	7 members of the Board of Governors are appointed by the President and confirmed by the Senate (veto power). RB Presidents are appointed by the Board of Directors, subject to final approval by the Board of Governors.
Frequency of MPM	1x month	1-2x month	1x month	8x year[171]
Decision-making process	Consensus (nemawashi) [172]	Majority voting	Consensus	Majority voting
Accountability	Collective	Individual	Collective	Individual
Publication of minutes	No	Yes (after next meeting)	No	Yes (before next meeting
Publication of transcripts	No	After 10 yrs	No	After 5 yrs
Government representatives	2 (but no voting rights)	2 may attend	President of ECOFIN and Commission	No

[171] According to the Federal Act (Section 12 A [a]), "at least four times each year". However, it is common practice to meet eight times each year.

[172] The decision-making process about monetary policy was characterized by a special consensus-building process (*nemawashi*). Miller (1996) describes this Japanese-style decision-making process with a so-called preclearance system.

Sources: Bank of Japan 2004; European Central Bank 2004; Homepages of the central banks.

5.2.2.3 The Responsibilities of the Bank of Japan

5.2.2.3.1 Banknote Issuance and Coins

Like many other central banks in the world, the BOJ is provided with the monopoly to issue banknotes (BJL, Articles 1 and 46), which act as legal tender in Japan. According to the BJL, Article 46, Paragraph 2, there is no limit given by the government regarding the amount of banknote issuance. The BOJ "shall determine the procedures regarding printing and cancellation of Bank of Japan notes", and it is required to "submit these procedures to the Minister of Finance for approval" (Article 49).[173] In addition, the Minister of Finance determines the forms of the notes (Article 47, Paragraph 2) and the types of the banknotes are decided upon by Cabinet Order (Article 47). In case of acute counterfeiting problems, the Bank may suggest a redesign of the banknotes to the Finance Ministry.

Since the revision of the Bank of Japan Law, banknote issuance has not been backed by assets. In contrast, the Bank of Japan Law of 1942 "required the Bank to hold prime assets equivalent to the amount of banknotes outstanding, and also had a maximum issuance limit system, which set the upper limit of the amount of banknotes outstanding." However, these conditions were eliminated by the 1998 Bank of Japan Law revision. Two main reasons might be responsible for this. First, in a fiat money system the value of banknotes should be stabilised through monetary policy and not through a direct connection with the Bank's amount of assets. Second, the importance of the banknote maximum issue system has decreased (Bodea and Huemer 2010: 50-51).

The issuance of coins is under the control of the Ministry of Finance. The "Law Concerning the Unit of Currency and the Issuance of Coins" (Clause 2, Section 4) states that "the issue of coins is affected by granting produced coins to the Bank of Japan, under order of the Minister of Finance." The BOJ's task is to put the coins into circulation and the publication of monthly data on the amount of coins (Bank of Japan 2002 Policy Planning Office; Bodea and Huemer 2010: 50-51).

[173] Banknotes are produced by the National Printing Bureau, which is a government agency.

5.2.2.3.2 Special Uncollateralized Loans (Lender of the Last Resort)

The 1942 BOJ Law stated that the Ministry may compel the BOJ to supply loans to any sector of the government (Article 25).[174] This clause was not completely revised, but Article 38 of the new law specifies this issue, claiming that "The Minister of Finance *may request* the Bank of Japan to conduct the business necessary to maintain the orderly financial system, including provision of loans…" (Italics added). This Article gives the impression that the Bank has the power to reject the Minister's request. Although the proposal for interventions in order to maintain an orderly financial system can be initiated by either the Bank of Japan or the Minister of Finance, the BOJ may conduct operations or not, and, thus, has the responsibility to function as the lender of the last resort.

5.2.2.3.3 Supervision, Regulation and Financial Stability: Prudential Policy – On-Site Examination

The government maintained a dominant position regarding the supervision of the banking industry. Articles 38 and 39 and to a somewhat lesser extent Article 37 clearly show the strong position of the government.[175] The prudential policy of the Bank of Japan is limited to the inspection and supervision and the lender of the last resort function (emergency liquidity injections) (Cargill, Hutchison and Itô 2000: 105; van Rixtel 2002: 211-212). The Bank of Japan's examinations "are not a separate or independent task, but a direct consequence of other tasks, in particular to conduct or prepare the provisions of temporary loans (Article 37), to implement business contributing to the maintenance of an orderly financial system (Article 38), and to conduct business contributing to the smooth settlement of funds (Article 39)."

In sum, the BOJ shares responsibilities concerning both macro-financial stability and micro-prudential supervision. However, this is restricted to financial institutions that have an account at the Bank. Furthermore, according to the obligation to maintain an orderly financial system (Article 1 and 2), the Prime Minister and the Minister of Finance may request the Bank to conduct business, including provision of

[174] The MOF exercised this right, for instance, in 1965 when Yamaichi Securities Company was provided with BOJ loans (Cargill, Hutchison and Itô 2000: 104).
[175] It is worth mentioning that this is totally in line with the recommendations made by the Central Bank Study Group in November 1996 (see, Chapter 3).

uncollateralized loans (Article 38). "Such government requests may cover financial institutions with insolvency (and not just liquidity) issues and imply a government guarantee that the BOJ will recover the loans." The BOJ may also provide uncollateralized loans to financial institutions on its own account in case of unexpected experiences of temporary shortages of funds for payment due to accidental causes (Article 37). Again, the requirement to inform both the Minister of Finance and the Commissioner of the FSA without delay prevails.

In contrast to the 1942 Bank of Japan Law, the new law legitimises the BOJ to carry out bank supervision through on-site examinations (kôsa) on the basis of its responsibility to maintain financial stability (as part of the lender of the last resort function). This authority is limited to those institutions the Bank is currently providing loans to, or expected to provide loans to in the future (Article 44). The BOJ's role in micro-financial supervision is indicated in the on-site examinations of financial institutions (Article 44). "In particular, the Bank conducts a risk-based examination aimed at ensuring that counterparties are sound. Examinations are carried out on a contractual basis for those financial institutions which have accounts at the Bank, and use the RTGS system" (Real-time gross settlement). Concerning micro-financial supervision, the BOJ shares responsibility with the FSA and upon request, the Bank may submit the results to the Commissioner of the FSA (Article 44, Paragraph 3). The FSA and the MOF exert some influence with respect to policy planning and legislative and policy proposals (Bank of Japan 2004: 38-39; Bodea and Huemer 2010: 50). It can be argued that through the interaction between the Bank and the Financial Services Agency (FSA) governmental influence is implemented in the BJL. That is, according to the Bank of Japan Law, the BOJ is requested to submit the results of on-site examinations to the Commissioner (Article 44, Paragraph 3). In order "to coordinate with the FSA and minimise the reporting costs of financial institutions, the BOJ pre-announces at the beginning of each fiscal year its schedule for on-site examinations."[176] In addition, "the Bank cooperates closely with the FSA by maintaining informal contacts at the top level and expert level, as well as exchanging in staff exchanges" (Bodea and Huemer 2010: 50). A document of the Bank of Japan states that:

[176] Regarding micro-supervision, although there is no formal institutional arrangement between the two institutions, "the decade-long financial crisis in Japan has enhanced cooperation" (Bodea and Huemer 2010: 50).

> "The Bank of Japan may also conduct other business when necessary, conditional upon the authorization of the Minister of Finance and the Commissioner of the Financial Services Agency (BOJ Law, Art. 43). Note that the Commissioner of the Financial Services Agency has been entrusted with the competence by the Prime Minister (BOJ Law, Art. 61-2). (Bank of Japan 2002c: 2)

On-site examinations are implemented under a contract between the Bank and the institution concerned. A clear legal basis for on-site examinations is manifested in the BJL Article 44, Paragraph 1. In total, until 2004, the BOJ had examination contracts with 565 institutions, including seven city banks, 64 regional banks, 50 regional banks II, 71 foreign banks, two long-term credit banks, 27 trust banks, 285 shinkin banks, and 42 securities companies (Bank of Japan 2004: 38-39 Annual Review). On-site Examinations between 2002 and 2011 conducted by the Bank of Japan can be seen in Table 5-2.

Table 5-2: On-Site Examinations Conducted by the Bank of Japan between 2002 and 2011

Fiscal Year	Total	Domestically licensed Japanese banks	Shinkin banks	Other (securities companies, Japanese branches of foreign banks
2002	115	35	67	13
2003	140	NA	NA	NA
2004	153	46	67	40
2005	160	42	73	45
2006	131	43	73	15
2007	119	39	66	14
2008	128	52	46	30
2009	112	46	47	19
2010	100	38	43	19
2011	68	26	29	13

Source: Own compilation based on Bank of Japan Annual Review 2002-2011; For Fiscal 2011: Bank of Japan: On-Site Examination Policy for Fiscal 2012, 30 March 2012.

5.2.2.3.4 Payment Systems, Securities Clearing and Settlement Systems

The BOJ does not only conduct monetary policy, simultaneously the Bank is obliged to ensure the smooth settlement of funds among banks and other financial institutions (Article 39), in order to fulfil its obligation of "contributing to the maintenance of an orderly financial system" (Article 1, Paragraph 2). Upon governmental request, the BOJ

may conduct businesses others than the regular business prescribed in Article 33.[177] However, the authorisation from the Prime Minister and the Minister of Finance is necessary. The BOJ may also provide financial institutions and other financial business entities specified by a Cabinet Order with uncollateralized loans (the period is prescribed by the Order) (Article 37). This lending activity is required to be reported without delay to the Prime and Finance Minister (Article 37, Paragraph 2).

In order to realize the targets in the settlement of funds, the Bank provides an assortment of payment and settlement services, such as the provision of means of payment (i.e. banknotes and deposits in current accounts held with the Bank),[178] and the operation of the BOJ-NET (Bank of Japan Financial Network System) Funds transfer system.[179] In securities settlements, the Bank operates the Japanese Government Bond (JGB) Book-Entry System and the JGB Registration System (Bank of Japan 2004: 64-68; 184-187). Moreover, the BOJ supervises the private payment and settlement systems. During the conduction of on-site examinations and off-site monitoring of financial institutions, the BOJ also estimates the risks for payment and settlement systems. In addition, the Bank cooperates with private sector providers of payment and settlement services to establish measures for risk reduction (Bodea and Huemer 2010: 49-50; Bank of Japan 2004: 55-78).

In the subject of payment and securities settlement, the Bank shares responsibilities with the Prime Minister (in charge of regulation and supervision) and, under delegated authority, with the Financial Services Agency. The major responsibility of financial institution supervision, including their payment and settlement functions lies within the FSA. However, the FSA and BOJ exchange information, although there is no formal framework for interaction on issues regarding payment and settlement systems.

[177] The regular business include (i) discounting of commercial bills and other bills and notes (ii) making loans against collateral (iii) buying and selling of commercial bills (iv) lending and borrowing of government bonds (v) receiving money for deposits (vi) dealing in domestic exchange, and (vii) taking custody of negotiable securities (BJL, Article 33).
[178] This measure was particularly important in the period of the quantitative easing policy between 2001 and 2006.
[179] For details, see Bank of Japan (2004: 47-78).

5.2.2.4 The Relationship with the Government

The relationship between the BOJ and the government was altered fundamentally in the new law. The BOJ was granted formal independence, whereas the government and the MOF lost a huge amount of their former legal control over the Bank. The main clause for the BOJ's independence is formulated in Article 3, Paragraph 1, which states that the "Bank of Japan's autonomy regarding currency and monetary control shall be respected" (*nippon ginkô no tsûka oyobi kinyû no chôsetsu ni okeru jishusei ha, sonchô sare nakeraba naranai*). In addition, the BJL states that "due consideration shall be given to the autonomy of the Bank's business operations" (*nippon ginkô no gyômu unei ni okeru jishusei ha, jûbun hairyo sare nakereba naranai*) (Article 5, Paragraph 2).

Regarding the authority to dismiss BOJ executives, this right of the government has been considerably retrenched. In detail, only in drastic cases, such as adjudicated bankruptcy, criminal behaviour or the incapacity to fulfil its duties, a removal is justified (Article 25). Most of the former authority of the Ministry of Finance over the BOJ was diminished. However, the MOF still maintains some power over the Bank. The most important aspect is its authority over the BOJ's budget (Article 51), which limits the Bank's financial independence. In addition, the appointment of the BOJ's Executive Directors and Counsellors are in the hands of the Ministry (Article 23, Paragraph 4).

In sum, the BOJ's independence towards the government is limited. The BJL claims that the Bank should maintain close contacts with the government and exchange views in a sufficient way in order to guarantee that monetary policy is "harmonious" (*seigôteki*) to the economic policy of the government (Article 4). The obvious contradiction of Article 3 and Article 5, Paragraph 2, with Article 4 leads to a high potential for conflicts between the Japanese government and the BOJ.[180]

Government financing

Regarding financial issues, the Bank of Japan acts as fiscal agent for the government, i.e., the Bank of Japan Law claims that the Bank is responsible for Treasury funds (Article 35) and national government affairs concerning currency and finance (Article

[180] See, analysis in Chapter 8.

36). The BOJ conducts the following operations on behalf of the government: treasury operations, government bond operations, custodial services for government-held securities, and foreign exchange market intervention (Bank of Japan 2002c: 7). The Annual Review of the BOJ (Bank of Japan 2004: 62-63) states that

> "The Bank acts as the custodian of securities acquired by or submitted (as collateral or deposits) to the government. The Bank receives, delivers, and stores such [Treasury funds; Financing bills] securities on behalf of the government"

Regarding financing the government, the BOJ might be requested to provide the government with uncollateralized loans, subscribe or underwrite government bonds, and subscribe or underwrite financial bills (Article 34). This Article of the BJL is critical to central bank independence as it does not indicate whether the BOJ has an independent choice to set limits for the purchase of the described financial operations. Rather, the law claims that the amount of uncollateralized loans and subscribed or underwritten government bonds are subject to a limit set by the Diet. In principle, the Public Finance Law (Article 5) prohibits the BOJ from underwriting government bonds and making loans to the government. However, this does not apply to "special cases" within the amount determined by the Diet resolution (Bank of Japan Law, Article 34, Paragraph 1).[181] In addition, the Public Finance Law (Article 5) prohibits the BOJ to "participate directly in the primary market for government securities." However, there are exceptions to this rule. The BJL, Article 34, Paragraph 3, states that the BOJ may subscribe or underwrite "government bonds to a limit imposed by a Diet resolution prescribed by the exception clause in Article 5 of the Fiscal Law" (Bank of Japan 2002: 4-5).

The Bank of Japan states that "the government (Ministry of Finance) determines the eligibility requirements for participating in bidding on primary issues of government securities (government bonds) and other matters related to primary issues (name and number, legal basis for each issue, issuing method, and other issuing conditions)" (Bank of Japan 2002c: 9). In order to secure a correct procedure of operations between the Bank and the government, the BOJ published a paper "Principal Terms and Conditions

[181] Article 34, Paragraph 1: "The Bank of Japan may […] making loans, without collateral, subject to a limit imposed by a Diet resolution prescribed by the exception clause in Article 5 of the Fiscal Law (Law No. 34 of 1947)" [sic].

for Transactions with the Government", which is determined by the Bank's Policy Board (Bank of Japan 2002c: 5).

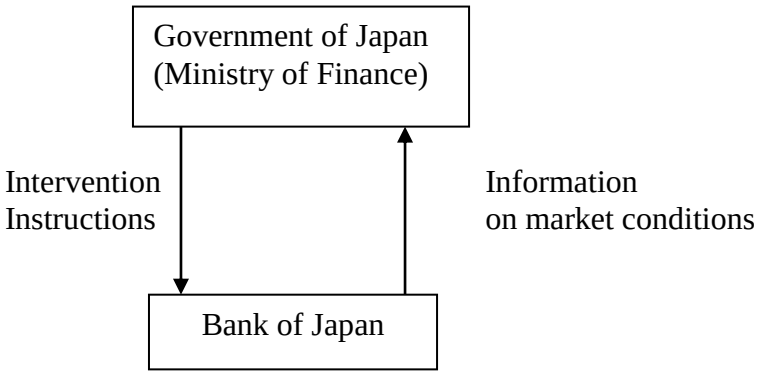
5.2.2.5 Foreign Exchange Rate Interventions

Regarding foreign exchange rate interventions, the Bank of Japan Law from 1942 stated in a rather unclear way that "[the BOJ] may, whenever deemed necessary, buy or sell foreign exchange" (Article 23). The issue was cleared to some extent in the new BOJ Law. Now the BOJ is authorised to carry out foreign exchange transactions on its own account as an agent of the government, including for the purpose of stabilising the exchange rate of the national currency, or as an agent of foreign central banks and international institutions, such as the Bank for International Settlements (BIS) (Article 40).

According to the Foreign Exchange and Foreign Trade Law (Article 7, Paragraph 3), the government has the responsibility for exchange rate policy: "the Minister of Finance shall endeavour to stabilize the external value of the Yen through foreign exchange trading and other measures". The BOJ makes use of funds from the Foreign Exchange Fund Special Account if it intervenes in the foreign exchange markets on behalf of the government.[182] Foreign exchange interventions and the accounting of the FEFSA are responsibilities of the government. The BOJ acts only as an agent to manage government financial operations, and purchases and sells foreign exchange in order to stabilize the domestic currency. This separation of responsibilities is lucidly stated in legislation (Law Establishing the Ministry of Finance, Art. 4; Foreign Exchange Fund Special Account Law, Art 6; Bank of Japan Law Art. 36, 40-2). In case of interventions in foreign currency markets, the MOF gives specific instructions to the BOJ. The BOJ Forex Division gathers real-time information, and provides this information to the Ministry (Figure 5-1). (Bank of Japan 2002c: 2; Bodea and Huemer 2010: 48-49). However, this arrangement of FEI has been criticized by some scholars. For instance, Cargill, Hutchison and Itô (2000: 104-105) argue that the law lacks clarity in the separation of responsibilities between the government and the Bank.

[182] This fund consists of foreign currency and Yen Funds. Short-term government bills (financial bills) are issued by the MOF to gain Yen for the funds which will be used to buy assets denominated in foreign currency. As a consequence, the interventions are automatically sterilised (Fatum and Hutchison 2006; Bodea and Huemer 2010: 48).

Figure 5-1: Foreign Exchange Rate Interventions



Source: Own compilation based on Bank of Japan (2004: 156)

5.2.4 Conclusion

As a conclusion for the previous sections about the old and the new Bank of Japan Law, Table 5-3 presents a comparative illustration of the Bank of Japan before and after the law revision in regards of central bank independence. This table demonstrates that the BOJ's independence has increased a lot.

Table 5-3: Comparison between the Old and the New Bank of Japan Law

	1942 BOJ Law	1998 BOJ Law	Important characteristics of the new BOJ
Central bank objectives	To promote full potential of the economy (Art 1 and 2)	Pursuit of price stability, and contributing to sound development of national economy (Art 2) Maintenance of an orderly financial system (Art 1-2)	Multiple goals: Price stability and support of the national economy
Banknote issuance	Limit set by Diet	BOJ has the task to issue banknotes (Art 46)	No limit set for banknote issue
Relationship to government	MOF had authority over a wide range of businesses (Art 43); Cabinet can dismiss the Governor and Deputy Governor (Art 47)	BOJ's autonomy shall be respected (Art 3 and 5-2); MOF's authority to control business removed. Governor cannot be dismissed (Art 25)	Higher level of independence for the BOJ
BOJ budget	MOF approves budget	MOF approves budget. In case of rejection, the MOF must give reasons	Higher level of independence. Still, very critical for financial independence
Special loans	Description unclear (Art 25)	MOF may request the BOJ to conduct business necessary to stabilise financial system (Art 38)	Better explanation of special loans
On-site examinations	No description	BOJ may enter into a contract with financial institutions regarding on-site examination (Art 44)	Better explanation of on-site examinations
Foreign	Not mentioned	BOJ may buy and sell foreign	BOJ has power to intervene.

Exchange Intervention		exchange on its own account (Art 40)	Still, authority over FEI by the MOF
Transparency and accountability	Not mentioned	Disclosure and transparency implemented (Art 3). Publication of minutes (Art 20). Report twice a year to the Diet (Art 54) Governor to Diet at request (54-3)	Accountability of BOJ to the Diet is enhanced

Source: Own compilation

The previous sections investigated the contents of the new Bank of Japan Law. The following section will provide an analysis of the Bank of Japan's independence, including a critical evaluation and examination of the limits of central bank independence.

5.3 Central Bank Independence of the Bank of Japan

5.3.1 Results of the New Bank of Japan Law

One key result of the previous section is that the new Bank of Japan Law of 1998 strengthened the central bank's institutional independence significantly. As argued above, Article 3 of the Bank of Japan Law states that the "…Bank of Japan's autonomy regarding currency and monetary control shall be respected…". Regarding business operations, Article 5 claims that "[…] due consideration shall be given to the autonomy of the Bank's business operations".[183] Since the Finance Ministry is cut off from some of its former control over the BOJ in the new BJL, the Bank is much more institutionally independent than under the institutional framework of the old law. According to Itô (2006: 106), the BOJ's institutional independence is "guaranteed in the sense that Governors as well as Policy Board members will not be dismissed unless physically or mentally incapacitated." In addition, since 1998 onwards the BOJ has experienced a significant increase in legal independence from the Ministry of Finance. In this regard, the BOJ is legally independent as the law provides the Bank with the task of price stability (Article 2), and the responsibility to contribute to the maintenance of a sound economy (Article 1). The BOJ's legal status is manifested in Article 6, namely

[183] The Bank of Japan Law uses the term "autonomy" (*jishusei*) rather than "independence" (*dokuritsusei*), a term which is widely used in the literature. The difference between both terms is that "autonomy entails operational freedom, while independence indicates a lack of institutional constraints" (Lybek and Morris 2004: 4, note 2). Kanda Hideki, an observer member of the FSRC subcommittee, demanded to scrutinize the two terms in more detail (Yomiuri, 26 February 1997). However, most Japanese sources do also use both terms alternately. For further explanations, see Kanegae (1999: 105-106).

that "[t]he Bank of Japan shall be a legal person".[184] Cargill (2006) argues that the capital structure of the central bank has implications for legal independence. However, the institutional device of the BOJ was completed without any meaningful changes to the distribution of stock ownership between government and public. Regarding the ownership of the Bank of Japan, the government invested 55 per cent of the paid-in capital of 100 million Yen, the other 45 per cent were provided by the private sector. In other words, the BOJ belongs to the rare and small number of central banks with private shareholders.[185] However, private shareholders are not allowed to interfere in the management of the BOJ (Kawakita 1995: 12-14).

The term of office for the Bank of Japan's Governor, the Deputy Governor's and the deliberative members of the Policy Board are five years, and all positions are provided with the option of reappointment (Article 24, Paragraph 2).[186] The new BJL strengthens the personal independence of the BOJ, and a dismissal of Board members through the Cabinet or the Finance Minister is only allowed if members are found guilty of serious misconduct, or are incapable of performing their duties correctly (Article 25) (Bebenroth and Vollmer 2007: 46). The fact that Japan is a parliamentary democracy is worthy of mention, i.e., the parliament elects the Prime Minister. As a result, a political change is only to be expected in the case of an election of a new parliament. Elections of the Lower House, the important chamber of the parliament, only take place every four years. As a consequence, the five-year term for Policy Board members is not long enough to guarantee political independence against the government.

Fujiwara (1998), member of the FSRC, which was in charge of the BOJ Law revision and BOJ Deputy Governor, elucidated what central bank independence means to him. An independent central bank is not only independent from politicians (*seiji kara no dokuritsu*) and government (*chôkan kara no dokuritsu*), but also independent from its past (*kako kara no dokuritsu*), and breaks with former practices such as the decision-

[184] However, there is no manifestation in the constitution as, for example, in the ECB. Article 108 of the EU Treaty claims independence for the central bank. Negrea and Munteanu (2008: 518) use the same argumentation of Article 108 to claim political independence for the ECB.
[185] Other countries are, for example, Austria, Belgium, Greece, Italy, Pakistan, South Africa, Switzerland, and USA.
[186] However, in 1998, there was an extraordinary exception. Four members were appointed to the Policy Board at the same time. To avoid the same situation four years later two members were appointed with a four year term (Miki and Nakahara). The other two members were provided with a two and three year term respectively and the possibility of a reappointment (Ueda and Shinotsuka).

making process and the practice of alternating Governors between the BOJ and the MOF.

Some observers argue positively regarding the new Bank of Japan Law. Matsushita, Governor from 1994 to 1998, said that BOJ Law revision towards central bank independence and transparency was the most significant event in the BOJ's 115 year history (Bank of Japan 1997, press conference 11 June 1997). According to Itô (2006: 106), the new law "is in every sense a state-of-the-art modern central banking law". Itô values the (single) mandate of price stability (Article 2) and the assurance of institutional independence due to the strengthened position of the Bank's key staff. Also, Ôshima and Ide (2006: 11) evaluate the new Bank of Japan Law as an increase in central bank independence to a high extent (*nichigin no hôteki na dokuritsusei ha oohaba ni kyôka sareru*). Iwata Kazumasa, BOJ Deputy Governor from 2003 to 2008, argued that the BOJ's de iure independence "has been significantly strengthened", mainly because the Policy Board is independent of interference in decision-making. Finance Minister Mitsuzuka stated in an interview that the new Bank of Japan Law secures the BOJ's independence and transparency in a way that meets the international standard (Yomiuri, 21 June 1997).

Regardless of the improvements in terms of central bank independence, there are many critical voices concerning the BJL revision. Critique of the new Bank of Japan Law was stated quite early, namely already during the drafting process. Prominent academics, such as Nakakita Toru, Professor of finance at Tôyô University and Okina Yuri, then-senior researcher at the Japan Research Institute Ltd., were disappointed by the report of the Prime Minister's private advisory panel upon which the current Bank of Japan Law is based on. The main point of criticism, for instance from Aizawa Kôetsu, economics Professor from Nagasaki University, was that the report failed to stipulate suitable methods to guarantee BOJ's independence and to clear up the relationship to the government. Above all, it failed to limit means of governmental interference (Aizawa 1997; Japan Times, 13 Nov 1996, 7 Feb 1997). Altogether, Miller (1996: 19) judges the Committee's report critically: "[t]he proposal is a masterful exercise in studied ambiguity, and it is sufficiently opaque to allow the MOF to continue to exercise powers over the Bank's activities that are quite similar to the powers it now [under the Bank of Japan Law of 1942] enjoys."

Similar to the draft of the CBSG (see, Section 3.5.6), the overall result of the new Bank of Japan Law revision is vague, and regarding some relevant issues of central bank independence disappointing. Murashima (2002: 267-272) states that some parts of the new Bank of Japan Law are too abstract and need to provide specific details, especially in the regards of the contradictions between Article 3 and 4. Some prominent observers argue that the vagueness of the BOJ can be explained in part by cultural aspects (*bunka*) of Japanese society.[187] Another aspect is the need for compromise (Moe 1990, 1995). In this case, the result of delegation will be weakened, because of an unavoidable compromise between different parties. The result of the Bank of Japan Law revision can be explained by Moe's assumption of the necessity of a compromise mechanism between the government and the MOF. As shown in Chapter 3, the MOF was highly involved in the process of reform, and was able to prevent the development of a central bank that was too independent. In addition, many politicians opposed an independent central bank, and were only willing to do so in order to survive the next election. As a consequence, a revised central bank law that progressed towards some more independence, but with many restrictions seemed to be a compromise most decision makers could live with.

As a result, several articles of the new law left a lot of room for interpretation. When comparing the Bank of Japan Law with central bank laws of other countries, it becomes evident that the Bank of Japan Law has legal weaknesses and significant limits in regards of its central bank independence. As noted by Tatewaki (1998: 166-167), especially Articles 4 and 19 of the new Bank of Japan Law are a sign of "extraordinary wide differences" (*kairi ha kiwamete ookii*) to global standards. Mikitani and Kuwayama (1998: 5-8) argue that the designers of the new law tried to impose an impractical separation of monetary policy and other responsibilities, e.g., acting as the government's bank, being the banker's bank and acting as an international monetary authority. The law respects independence only when the execution of monetary policy is conducted, but not in the case of other functions. Moreover, it explains in detail matters that belong to the BOJ and implicitly leaves the rest to the MOF. Another issue that imposes some problems is the BOJ's position under the new constitution. It is rather

[187] Interview with former MOF official on 30 October 2009, and banking official on 31 July 2009.

ambiguous whether the Bank answers to the Diet, or the Cabinet, or if it is indirectly a subordinate organ of the MOF.

To sum up, there is no objection to calling this central bank law revision an imperfect reform (Mabuchi 1997: 72). Dwyer (2004) quotes Taketomi (1997) and Suzuki (1997) who concluded that the new law granted the BOJ a somewhat lower degree of independence and a little higher degree of transparency than the international standard. Due to various deficiencies and ambiguities in the new law, it is possible to doubt whether the BJL meets the international standard. The next section analyses these deficiencies and ambiguities and critically assesses the new Bank of Japan Law in more detail.

5.3.2 A Critical Assessment of the New Bank of Japan Law

Kanegae (1999: iv) questions how the new Bank of Japan Law was implemented in such a fast way. The reason might be that the reform was conducted merely by politicians. If reform had been accomplished by government bureaucracy, central bankers, and academic experts, it would have taken much more time. Indeed, Chapter 4 of this thesis demonstrated that the process of central bank law revision, from the beginning to the promulgation did not take much longer than one year. This may explain why the new Bank of Japan Law lacks clarity in many respects. Basically, lawmakers and their advisers did not have enough time to think and work out all debatable issues in a sufficient way.[188] This chapter debates aspects of the new BJL which were criticized most by observers.

1. The BOJ's Objective
2. Relationship with the Government
3. The Right to Postpone BOJ Monetary Policy Decisions
4. Critique on the BOJ's Financial Independence

[188] Needless to say, several clauses that weaken the BOJ's independence might be implemented deliberately due to political reasons.

1. The BOJ's Objective

General consensus exists that a single goal is preferable over multiple goals for central bank independence and the adequate execution of monetary policy. Issing (2012: 57-59) argues that the problem of a dual objective for a central bank is that the central bank most likely seeks to achieve only one goal at a time, which is problematic from a constitutionalist point of view. For example, a clearly formulated and single monetary policy goal enables adequate monitoring and promotes the accountability of a central bank. Glastra (1997: 324-325) argues that "The announcement of a single goal (or a primary goal), rather than several unranked goals, enables authorities and public opinion to control [a central bank's] performance more effectively."

In the 1990s, the vast majority of economists reached a common agreement that "price stability should be the primary objective of monetary policy" (Laurens et al. 2009: 6). However, many central bank laws are rather ambiguous regarding supreme goals, or "contain various (possibly conflicting) objectives without giving indications as to their prioritisation." Still, a clear objective is very important for every economic actor. For example, quoting Goodhart (1993: 4), "it will always be possible for the Governor to say: Well, we have lived in a very difficult world, doing everything we can to achieve price stability". In other words, it is always possible to find excuses if the central bank is not reaching the policy targets of the principal. Therefore, it is important to formulate clear objectives for the central bank.[189] The clearer the objective of monetary policy is formulated in the statutes, the more independent the central bank is. Various central bank independence indices demonstrate this fact. If price stability[190] is the central bank's single goal, the Bank is more autonomous, since the degree of priority given to this goal indicates the degree of conservatism imparted by the Bank's statutes (Arnone et al. 2006: 23).

[189] A notable exception is the Reserve Bank of New Zealand: the Bank's Governor has to consent with the government over the target range of inflation which is clearly defined in the Policy Target Agreement (de Haan, Amtenbrink, and Eijffinger 1998: 5).

[190] However, the term of price stability has different interpretations: price level constancy or zero inflation. Depending on the definition, the goal of long-run price level constancy provides low uncertainty regarding the price level for the long run, but high uncertainty for the short run, respectively vice versa for the goal of zero inflation (Fischer 1995). In other words the central bank (for the ECB, de Haan 1997) has "some room of manoeuvre" regarding the objectives of monetary policy (de Haan, Amtenbrink and Eijffinger 1998: 4).

Starting with the central bank's objective, the Bank of Japan Law fails to specify price stability, and takes for granted that the objectives of price stability (Article 2) and the objectives of maintaining financial stability (Article 1) do not conflict with one another. Kanegae (2007: 3) cites the "Bank of Japan's Independence Study Group" (*nippon ginkô no dokuritsu sei ni kan suru kenkyû kai*), which claims that the BOJ's objective should focus on price stability. Shiratsuka (2001: 50) acknowledges that the new law does not provide a clear definition of the term price stability, and, as a consequence, "a consensus has yet to be gained as to how to transform it [price stability] into the practice of monetary policy." Regarding its second objective, Shiratsuka argues that there is no trade-off between price stability and output in the long run. Hence, a central bank should concentrate on a low and stable inflation rate.

Many academics dispute over the question whether price stability can be considered as the supreme goal of Japanese monetary policy. For example, Hasan and Mester (2008) and Itô (2009: 64) falsely identify price stability as the single goal of the Bank of Japan. The majority of scholars, including Gerdesmeier et al. (2007), Kanegae (1999: 97), Yamawaki (2002: 202), Bini-Smaghi and Gros (2001), Fujii (2004: 90), and Ôshima and Ide (2006), disagree and argue that the BOJ has multiple monetary policy objectives, namely price stability and the maintenance of an orderly financial system. Eijffinger and Geraats (2006: 13) criticise that the Bank of Japan Law does not formulate an explicit prioritisation, or a precise definition, or quantification of its objectives (see, also Chapter 6). Regardless of a final evaluation, it is indisputable that price stability is determined as a clear responsibility of the BOJ, whereas the responsibility for financial stability is shared with the government. Bebenroth and Vollmer (2007: 45) argue that the new Bank of Japan Law "explicitly claims a harmony between price stability and economic development."

The Bank of Japan interprets its monetary policy objective two-folded. The first objective is the pursuit of price stability (*bukka no antei*), and the second is the stabilisation of the financial system (*kinyû shisutemu no antei*), which is defined by the BOJ Law (Bank of Japan 2000; Interview with Shirakawa, 8 April 2010). The BOJ itself stated that "The Bank of Japan is called upon to make a positive contribution to the sound development of Japan's economy by pursuing monetary policy aimed at price stability, securing a smoothly functioning system of payments and settlements, and

contributing to financial system stability." (Bank of Japan, Annual Review 2003: 65). Fujiwara (1998), who was a member of the FSRC, which was in charge of BOJ Law revision, also emphasizes the existence of multiple goals of the BOJ Law.

Regarding price stability, in October 2000 the BOJ published a report "On price stability" (*bukka no antei ni tsuite*). The report is not very clear, stating that "price stability is a condition that is neither inflation nor deflation" (*bukka antei to ha, infure demo defure demo nai jôtai*). Similarly, the report's explanation of price stability as "an environment where economic agents including households and firms can make decisions regarding such economic activity as consumption and investment without being concerned about the fluctuation of the general price level" lacks sufficient accuracy (Bank of Japan 2000: 3). Naturally, there are some critical voices regarding the BOJ's objectives. Iwata (2008) goes quite far by comparing the goals of the BOJ with the US Federal Reserve, arguing that the BOJ follows two goals without clear priority: "[t]he dual mandate of sustainable growth under price stability is similar to the maximum employment and price stability mandate of the Federal Reserve."[191] Ôshima and Ide (2006: 10-11) provide another important interpretation, namely that the BOJ Law's term for price stability (*bukka no antei*) avoids the broader term of currency stability (*tsûka kachi no antei*), which is related to both price and exchange rate stability. This indicates that interventions in foreign exchange markets are still the responsibility of the government (see, also discussion in Mabuchi 1997: 79-80).

The different viewpoints about the BOJ's monetary policy objectives demonstrate that the formulation of this important issue is not clearly defined in the new Bank of Japan Law. As a result of the imprecise definition of price stability in the new BJL and documents of the BOJ, financial markets and BOJ watchers have difficulties to fully understand monetary policy decisions made by the BOJ. When studying statements and speeches made by Policy Board members regarding price stability and the output gap to explain changes in the central bank's monetary policy, it becomes clear that members have different approaches regarding price stability. This problem could be avoided if there was a precise definition of price stability.

[191] Under the quantitative easing policy between 2001 and 2006, the BOJ followed a primary goal of price stability and the exit of deflation.

2. Relationship with the Government

Article 4 of the new law states that the Bank has to "…always keep close contact with the government and exchange views sufficiently so that its currency and monetary control and the basic stance of the government's economic policy shall be mutually harmonious". In practice, the exercise of this clause can mean everything and the interpretation of this article is wide-ranging. In its most benign interpretation, it could mean that only exchanges of views are conducted, whereas other interpretations assume concrete policy requests from the government to the BOJ.[192]

Tatewaki (1998: 85-86) criticises Article 4, specifically pointing out that this Article can be interpreted as the central bank's duty (*gimu*) to set up direct transmission lines of communication with and to provide information to the government. In times of disagreement about the suitability of the policy, this arrangement can be harmful, or represent a "sacrifice" (*gisei*) to price stability.[193] However, it can be argued that the obligation to "maintain close contact with the government" is not restricted to the BOJ, but rather a common feature of many central bank laws. The main problem in the Japanese case is the phrase "always" (*tsune ni*) in Article 4. This expression requires, in a legal sense, that the Bank has to consult permanently with the government in all cases, even in situations in which cooperation between a central bank and the government may be harmful.

Another limit of functional independence is Article 38. The Prime Minister and the Finance Ministry can force the BOJ to conduct necessary businesses to maintain a stable financial system. Although the law uses the wording "may request", the government has enough tools to exert pressure on the Bank of Japan. Article 34 of the BJL is also critical for functional independence, for it claims that the BOJ may give loans without collaterals to the government subject to a limit imposed by the Diet, finance the

[192] During the Law revision Japan's Prime Minister Hashimoto and Kitawaki from the Shinshinto Party hold the viewpoint that the BOJ should maintain close contact with the Diet. The result can be seen in Article 4 of the new law, which makes the BOJ an implicit subordinate of the government. The statement that the policies of the Bank and government "shall be mutually harmonious" shows a crucial assumption that the government has on behalf of the BOJ. The conclusion seems obvious: Policymakers wanted to believe that the BOJ would act as cooperatively as always and would easily bow to political pressure (Lukauskas and Shimabukuro 2006: 136-137).

[193] The author mentions the period of severe inflation after the oil shock and the bubble after the Plaza Accord in which directives to the BOJ led to unfavourable results.

government's temporary borrowing and subscribe or underwrite government bonds (also subject to a limit by the Diet).

3. The Right to Postpone BOJ Monetary Policy Decisions

Some academics, such as Ôkina Yuri, criticise the fact that government officials are allowed to participate in Monetary Policy Meetings according to Article 19 of the Bank of Japan Law (JT, 13 November 1996). Hall (2008: 129) argues that although the government representatives are not permitted to vote, their "presence is a constant reminder of the contingency of the Bank of Japan's also quite recent independent status." [194] The law even allows the government representatives to call for a postponement of policy decisions. The right to postpone BOJ decisions (Article 19, Paragraph 2) is a fundamental constraint of the BOJ's functional independence.[195] Kanegae (2007: 3) cites the "Bank of Japan's Independence Study Group", which states that the presence of government representatives in the BOJ's Policy Board is dispensable, and especially the right of postponement contradicts the concept of central bank independence.[196]

4. Critique of the BOJ's Financial Independence

Financial independence is an essential prerequisite for an independent central bank. The BOJ was granted enhanced financial independence in insignificant budget matters, i.e., the Bank could "determine the standards of salaries paid to its executives and staff, consistent with the general standards prevailing in society" (Article 31). However, apart from that, financial matters of the BOJ lack substantial requirements of independence, and, in fact, the Bank of Japan's financial independence is particularly limited. Regarding financing the government, the BOJ might be requested to provide the government with uncollateralized loans, and to subscribe or underwrite government bonds and financial bills (Article 34). This article is critical to central bank independence because it does not indicate whether the BOJ has the independent

[194] It has to be noted that according to Bini-Smaghi and Gros' (2001) accountability index, the participation of government representatives increases the central bank's accountability.
[195]Article 19 stipulates that the Minister of Finance and the Minister of economic and fiscal policy have the right to attend and express views at Monetary Policy Board Meetings (Paragraph 1) and may request the delay of monetary policy decisions (Paragraph 2).
[196] Mabuchi (1997: 309-312) states that Nakanishi from the FRSC subcommittee compared the right to postpone a vote to the right of giving orders. In the 6th meeting of the FRSC he demanded a correction of the postponement article. Chairman Tachi later said in a press conference that there are no objections in the committee regarding this issue.

authority to set limits for the purchase of the described financial operations. Moreover, certain scholars claim that the right of the MOF to decide over the Bank's budget (Article 51) is simply not an ideal design for an independent central bank. Kanegae (2007: 3) cites the "Bank of Japan's Independence Study Group", which claims that the Policy Board should autonomously decide about its budget. It is sufficient if the government is informed and the budget is inspected by the Board of Audit (*kaikei kensa in*). Mikitani and Kuwayama (1998) argue that budget issues in the new BJL are solved quite uncommon, because the Bank is required "to prepare a current expenditure budget with current expenditures to be determined by a government Cabinet order." According to the Bank of Japan Law, Article 51,[197] the BOJ must obtain prior authorization from the government (Minister of Finance) for its budgeted expenditure before each business year. A serious problem of a budget plan is how to separate monetary and non-monetary policy operations (Mikitani and Kuwayama 1998). In case of non-authorisation, the Ministry must declare the reasons publicly. The Bank may express its views to the Minister of Finance, or, if necessary, announce them publicly. Article 52 claims that the Bank must submit financial statements every six months, such as the inventory and balance sheet in combination with the Executive Auditors' opinion to the Minister of Finance. After having received his approval the report shall be published.[198]

The surplus of the Bank's operations has to be transferred to the Ministry of Finance. Ten per cent of the amount is deduced as inflow to the reserve fund, and a dividend is paid to shareholders (Bebenroth and Vollmer 2007: 46). The formulation in Article 53 (Disposal of surplus) hinders financial independence, and endangers the institutional setup of the Bank of Japan. The important question what happens if the Bank's operations result in a settlement of losses is not cleared.[199] In several countries, such as Japan, Finland and Switzerland, financial independence of the central bank has become an issue of public interest (Bindseil, Manzanares and Weller 2004: 8; Martinez-Resano 2004: 7). In fact, the financial status of the BOJ has been the subject of fiery debates in recent years, particularly the issue of balance sheet risk as a side effect of the

[197] "Every fiscal period, the Bank of Japan shall prepare a budget for general and administrative expenses, and submit it to the Minister of Finance for his or her authorization before the business year begins."
[198] According the IMF (2000: 76), the majority of central banks have to disclosure its financial data annually. Exceptions are besides Japan, the central banks of Albania, Angola and Slovakia.
[199] For legal problems of Article 53, see Oritani (2010: 25).

quantitative easing policy which was conducted between 2001 and 2006.[200] Yamawaki (2002: 125-126) observes that BOJ officials did not claim independence over their own budget during the BJL revision process, but rather were ready to compromise, agreeing that the budget is an issue which requires approval by the Diet. However, an independent central bank should be responsible for the management of its own budget, and should not be dependent on the Ministry of Finance.

5.3.3 Constitutional Doubts about the Bank of Japan Law

During the BJL reform process discussions about independent agencies (*dokuritsu seifu kikan*) and doubts about the constitutionality of the Bank of Japan legislation emerged (Nakakita 2001: 74-75; Oritani 2010: 20; Ôshima and Ide 2006: 11). Article 65 of the Constitution of Japan reserves executive authority to the Cabinet.[201] The Bank of Japan (2000: 27-28) states that during the revision of the Bank of Japan Law, a discussion emerged concerning the independence of the BOJ. Japan's Cabinet Legislation Bureau (CLB; *naikaku hôsei kyoku*) issued a statement that the "executive branch of the government should have control of the "budgetary authority" and "appointive authority" in order to meet the conditions of the Constitution, Article 65. However, according to the Bank of Japan, both the Cabinet's power over the appointment (Article 23) and the control over the "budgetary authority" (Article 51) should be questioned.

The different positions suggest that the legal position of the BOJ is ambiguous. According to Japan's Constitution, there are three branches of government: the legislature, the executive, and the judiciary. The Central Bank Study Group regarded the BOJ as part of the executive branch, which, on basis of Article 65 of the Constitution, belongs under the direct authority of the Japanese Cabinet. On the contrary, MOF officials agreed with the argument that the Bank of Japan is part of the "administrative" branch. Hence, the central bank must report to the Cabinet by means of the Ministry of Finance. Mikitani and Kuwayama (1998: 19-20) argue that the practical implication of the constitutional setting is that the BOJ has to report indirectly to the Diet, a fact that might be interpreted as proof that the BOJ is not an independent agency:

> "Whether out of confusion, or based on a new interpretation of the Constitution, the practical implication of this is found in the reporting

[200] See, detailed analysis in the following chapter.
[201] For a detailed summary of the discussion about Article 65 of the constitution, see Yamawaki 2002, chapter 3).

> provisions of Article 54 of the new law. Entitled "Reporting to the Diet", this section sets down a welcome requirement of accountability by requiring the Bank of Japan to report approximately every six months on all of the Policy Board's policy decisions and on operations to carry them out. But the law instructs the BOJ to submit its report "to the Diet through the Minister of Finance": It is hard to see what purpose is served by making the BOJ report indirectly, other than to underscore that it is not an independent agency with responsibility directly to the Cabinet."

Regarding the issues of appointment and budget, the so-called Study Group on the Central Bank from the Perspective of Public Law (*kôhôteki kanten kara mita chûô ginkô ni tsuite no kenkyûkai*)[202] under the chair of Professor Shiono Hiroshi from Tôa University (and Professor Emeritus of the Tôkyô University) was established to investigate both the issues of "appointive authority" and "budgetary authority".[203] A conclusion was reached that the Cabinet Legislation Bureau is mistaken. Regarding "appointive authority", the Study Group stated that "the Cabinet's control over the appointive authority of the Bank of Japan is not a condition for securing constitutionality", and, "considering that the policy and operations of the Bank of Japan are entrusted to it by the nation, involvement of the Cabinet and the Diet in the staff matters of the Bank of Japan should be perceived from the perspective that the public should select the person that bears ultimate responsibility for what they entrust". Regarding "budgetary authority", the Study Group concluded that "the Cabinet need not have budgetary authority over the Bank of Japan in order to prove that the Bank is under the authority of the Cabinet subject to the Constitution". The Study Group justified its conclusion, stating that "although the Cabinet Legislation Bureau mentioned budgetary authority and appointive authority as a basis for the constitutionality of the Bank of Japan Act, if true, then even the Supreme Court can be said to be under control of the Cabinet" (Bank of Japan 2000: 27-28; translated by Oritani 2010: 21).

[202] The group consisted of 4 law experts (respectively, five from January to June 1998). Shiono (2001: 3) adds that Bank of Japan staff joined the group meetings too.

[203] Dwyer (2004: 256) notes that MOF officials regarded the politically dependent Bank of England (BOE) as a model for the Japanese central bank and lobbied for a high degree of government influence over budget issues and the empowerment to intervene in monetary policy issues. The Diet refused many of the MOF's suggestions. However, the MOF was quite successful in influencing the process of central bank reform to their favour. Brown (1999: 174) observes that the article that empowered the finance minister to control the budget of the Bank of Japan was a success of lobbying MOF officials.

5.4 Central Bank Independence Indices

5.4.1 Introduction

One principal question underlying the topic of independent central banks is how to measure central bank independence. A large body of literature exists about the measurement of central bank independence. This section summarizes the most important central bank indices. Section 5.4.2 explains why central bank indices are problematic and section 5.4.3 draws some conclusions for Japan.

Regarding the central bank's own assessment of independence, Sterne (2000: 109-112) develops a survey and sent it to central banks asking question such as "how would you define central bank independence?" Sterne (2000: 110) summarizes his findings as follows:

> "Almost all central banks considered instrument independence to be an important aspect of independence. By contrast, goal independence tends to be important to central banks in particular circumstances […] only 22% of respondents mentioned the ability to set targets, objectives or goals, while 38% defined independence by stressing the importance of legal objectives."

Central bank independence indices can be distinguished into two groups: De iure and de facto indices. De iure indices are typically derived from central bank statutes and contracts, while de facto indices are usually based on surveys (Freytag 2002: 41). The most common methodology is to build an index of central bank independence based on an arrangement of institutional and legal aspects (de iure index). Standard proxy measures for central bank independence rely on interpreting quantitative measures for formal institutional arrangements. There are proxies of almost all aspects of central bank independence, including appointment procedure, the Bank's monetary policy decision-making body, and the interaction with the government. Behavioural features are considered only by a small number of papers. However, the vast divergence of the various indices suggests that there is no standard methodology for analysing und building measures of central bank independence.

For instance, in a prominent paper Cukierman, Webb, and Neyapti (1992) propose a complex de facto central bank independence index based on three aspects of actual independence. The first aspect is the average turnover rate of Central Bank

Governors.[204] Second, an index structured using the results of a survey conducted in central banks, which focuses on central bank practices. And third, an aggregation of the de iure index and the average rate of turnover. The Cukierman, Webb, and Neyapti index was the first central bank independence index which emphasizes the possibility of a wide gap between the de iure and the de facto independence of a central bank. The formal statute of the central bank affects its real independence, but there also many other determinants, such as "informal arrangements or actual practises, the personalities of the key staff and the quality of research at the central bank." (Arnone et al. 2006: 14). It is important to consider whether the proxies on independence should have an equal weight, or whether important aspects should be given a higher (or lower) factor. The majority of literature has followed the way to weight all variables equally in order to reduce the potential for arbitrariness. However, there are considerable exceptions, most notably, Cukierman, Webb, and Neyapti (1992).

5.4.2 Critique of Central Bank Independence Indices

There are many "obstacles" within the empirical literature of central bank independence, "but the most challenging has been the measurement of the independence of monetary authorities" (Alesina and Stella 2010: 15). As a result, the application of central bank independence measures is controversial and is subject to conceptual and empirical problems (Forder 2000). For instance, Laurens et al. (2009: 32) argue that "it is difficult to construct a central bank independence measure that is unbiased. In particular, even subtle differences in defining a variable, especially within de iure indicators can generate large discrepancies in results." That means that every indicator is somewhat subjective, and only measures a limited division of reality.

Considering the vast amount of literature on this subject, it is no wonder that the term is used in different definitions and methodologies (de Haan 1997; Forder 1998, 1999; Mangano 1998). Many studies of central bank independence are "quite sloppy" when it comes to a clear definition of the term central bank independence (de Haan 1997: 397). Due to these difficulties, Forder (1996: 44) rejects central bank independence measurement, declaring that "it is quite clear that the reading of statutes is not a measure

[204] This measure is problematic as a little turnover rate alone is not evidence enough for an independent central bank. It is also conceivable that the Central Bank Governor is just willing to accommodate the government requests (de Haan and Kooi 2000), and, therefore, has a long tenure.

of independence in the sense required by the theory which suggests that independence is useful. The most it might provide is a measure of formal, legal independence. But such independence is not economically significant. There is no theory that says it matters what the rules say. There is only a theory that says it matters what the behaviour is." According to Cargill (1995: 163), "the basic problem with indices is they ultimately rely on a researcher's interpretation of central bank laws". James (2010: 14) argues that scholars "surprisingly often" find mistakes in central bank measures, especially in countries scholars know best. In contrast, in the case of more distant countries, scholars are usually more willing to accept the results of the central bank measures. For instance, Grilli et al. (1991) overestimate the independence of the French National Bank; Alesina (1988) criticises the method of Bade and Parkin (1988) regarding the estimation of the Bank of Italy; and Eijffinger and de Haan (1996) argue that the central bank of the Netherlands is more independent than evaluated in Cukierman, Webb and Neyapti's index (1992). Due to these inconsistencies, James (2010: 14) concludes that "an apparently rigorous scientific exercise becomes very quickly and evidently random and arbitrary."

The main argument of critics concerning central bank independence (e.g. Forder 1996; Banaian, Burdekin, Willett 1995, Eijffinger and de Haan 1996, Mangano 1998), is that the interpretation of central bank statutes has no meaning when it comes to identifying a central bank's de facto independence, but rather depends on the actual behaviour of the main actors. The statute of a central bank might be fundamentally diverse from concrete practice (Alpanda and Honig 2010). In other words, de iure independence is insufficient to explain the actual behaviour of the central bank and its relationship to the government. The history of central banking provides several examples which verify that statutorily dependent central banks may act independently and vice versa.[205] For instance, Maxfield (1997: 21-22) demonstrates that the actual behaviour of central banks illustrates more variations than the central bank law. Rather than to a determined index, central bank independence is related to concrete behaviour of players, in particular the Central Bank Governor and the Prime Minister. This explains why actual central bank

[205] For instance, Mishkin (2004a) argues that the Bank of Canada is legally a dependent central bank, because the government has the ultimate responsibility over monetary policy. In practice, however, the Bank of Canada acts quite independently. On the contrary, the central bank of Argentina, although legally highly independent, is exposed to government pressure. For example, in 2001, the Argentine government dismissed the vastly respected central bank president Pedro Pou and replaced him with a president loyal to the government.

independence differs over time, although the statute of the central bank remains the same. However, the vast majority of central bank independence literature concedes that well-constructed indices provide a good overview, and may provide a rough idea of how central bank independence is institutionalized and interpreted in a certain country. In the following section, this thesis aims to identify, to analyse, and to clarify mistakes and misconceptions about central bank indices in the application of the Bank of Japan.[206]

5.4.3 The Bank of Japan and Central Bank Independence Indices

This section presents the results of various central bank independence indices before and after the 1998 BOJ Law revision. For reasons of comparison, this section offers the data of three other major central banks, namely the German Bundesbank (for the old BOJ Law) or ECB (for the new BOJ Law), the US Federal Reserve, and the Bank of England. This section provides a summary of the most popular central bank independence indexes and their results regarding the Bank of Japan.

5.4.3.1 Evaluation of the Bank of Japan Law of 1942

As demonstrated in a previous section, under the 1942 BJL the BOJ was highly dependent on the government. Most central bank indicators confirm this, and rate the BOJ as having a low amount of central bank independence in comparison to other major central banks in the developed world. For example, the often-quoted Cukierman, Webb, and Neyapti (1992) index ranked the independence of the 1942 BOJ with 0.18 points on a scale ranging from 0 to 1, in which zero stands for the lowest degree of independence (Table 5-4). This result is on the same level as central banks in, e.g., Pakistan, Morocco, or Panama. Another rating was made by the simple Bade and Parkin (1988: 8) index, which is based on four proxies for central bank independence. This index rates the BOJ with a relatively high degree of central bank independence, namely three points out of four, or in normalized values 0.75. That is the same level as the US Federal Reserve. Bade and Parkin (1988) mistakenly argue that the Policy Board of the BOJ, under the 1942 BJL, had extensive powers in regards of deciding the operation of business, fixing and changing rates of discount, changing the qualifications of bills to be discounted, fixing, changing, and abolishing maximum rates of interest, reserve ratios, and controls

[206] For details, however, one has to consult concrete case studies and the application of the central bank law in a de iure environment what will be conducted in Chapter 8 of this thesis.

over loans. However, the result by Bade and Parkin (1988) is misleading and needs correction.

Table 5-4 presents selected central bank independence indices, and compares the results for the Bank of Japan with other central banks, namely the German Bundesbank, the US Federal Reserve, and the Bank of England. The results demonstrate that the Bundesbank is the most independent central bank, followed by the US Federal Reserve. Taking the mean value of all seven indices into account, the BOJ has a significant higher result than the Bank of England (0.52 versus 0.41). However, omitting the misleading result of Bade and Parkin (1988) and Alesina (1988, 1989), the result of the BOJ is comparable with the Bank of England.

Table 5-4: Results of Selected Central Bank Independence Indices (before 1998)

	Japan	Germany	US	UK
Bade, Parkin (1988)	0.75	1	0.75	0.5
Alesina (1988, 1989)	0.75	1	0.75	0.5
Grilli, Masciandaro, Tabellini (1991)	0.38	0.81	0.75	0.38
Burdekin, Willett (1991)	0.33	1	0.67	0.33
Cukierman, Webb, Neyapti (1992)	0.18	0.69	0.48	0.27
Alesina, Summers (1993)	0.63	1	0.88	0.5
Eijffinger, Schaling (1993)	0.6	1	0.6	0.4
Mean Value	**0.52**	**0.93**	**0.7**	**0.41**

Source: Own construction based on the central bank indices
Note: Numbers are in normalized values

One can interpret the different results that emerge in various central bank independence indices as evidence that there is not much consensus in economic literature on how to measure central bank independence appropriately. In particular, the classification of the Bank of Japan is a problem in the existing literature and reveals many contradictions (Botzenhardt 2001: 22, 41, 49; Mangano 1998; Acemoglu et al. 2008). For instance, veto rights of the government implemented in some central bank laws are difficult to measure due to their mainly formal character. Botzenhardt (2001) combines the most essential indices and ranks the central banks on a scale between 1 and 10 (Table 5-5).

Table 5-5: Rankings in Selected Central Bank Independence Indices (before 1998)

	BOJ	Bundesbank	Fed	BOE
Bade, Parkin (1988)	**3.5**	1.5	3.5	7.5
Alesina (1988, 1989)	**3.5**	1.5	3.5	7
Grilli, Masciandaro, Tabellini (1991)	**8.5**	1	2.5	8.5
Burdekin, Willett (1991)	**7**	1.5	3	7
de Haan, Sturm (1992)	**8.5**	1	2	6
Cukierman (1992)	**10**	2	3	6
Eijffinger, Schaling (1993)	**4**	1.5	4.5	8
Alesina, Summers (1993)	**5**	1.5	3	8
Fratianni, Huang (1994)	**8**	1	3	4.5
Medium	**6.5**	1.39	3.11	6.94
Standard deviation	**2.29**	0.31	0.66	1.19
Difference max-min	**6.50**	1.00	2.50	4.00

Source: Based on Botzenhardt (2001: 78)

Table 5-5 demonstrates great divergences between various indices for the Bank of Japan and compares them with other central banks. A difference of 6.50 points between the highest and lowest index, which is the highest value of all samples, demonstrates the heterogeneity of various indices. In relative numbers the indices demonstrate a difference of 64 per cent for the BOJ.[207] Mangano (1998) argues that the independence of the Bank of Japan is one of the most controversial. For instance, two of the most prominent central bank independence indices, the Grilli, Masciandaro Tabellini index (1991) and the Cukierman (1992) index[208] have an average difference of nearly 50 per cent in their assessment of the Bank of Japan.[209]

5.4.3.2 Evaluations of the Bank of Japan Law of 1998

This section analyses central bank independence indices regarding the "new" Bank of Japan. One essential form of index is the Cukierman, Webb, and Neyapti index (1992). Cargill, Hutchison and Itô (2000) employed this index to examine to which extent the legal independence of the BOJ improved after the BJL revision. The value of 0.39 for the new BOJ demonstrates that the central bank's independence had enhanced

[207] In the whole sample, only the central bank of Canada has with the value with 70 per cent a higher result.
[208] This index is similar to Cukierman, Webb, and Neyapti (1992).
[209] Other central banks that have a high spread are from Denmark, France and Greece.

fundamentally in comparison to the prior value of 0.18 before the BJL revision. Table 5-6 provides a detailed list of the updated index. In comparative rankings, the BOJ's independence improved its rank to the middle range (see, Appendix A for the construction and coding of Cukierman, Webb, and Neyapti central bank independence index).

Table 5-6: The Cukierman, Webb, and Neyapti (1992) Index – Comparison between the Old and New BOJ

	Factor	Old BOJ	New BOJ	Score old BOJ	**Score new BOJ**
Component					
1. Governor/CEO (Weight in overall index = 20%)					
a. Lengths of term in office	0.05	0.5	0.5	0.025	**0.025**
b. Who appoints the CEO?	0.05	0.25	0.75	0.0125	**0.0375**
c. Provisions for dismissal	0.05	0.83[210]	0.83	0.0415	**0.0415**
d. May CEO hold other offices?	0.05	0.5	1	0.025	**0.05**
Subtotal	0.2			0.104	**0.154**
2. Policy formulations (Weight in overall index = 15%)					
a. Who formulates monetary policy?	0.05	0.67	1	0.0335	**0.05**
b. Who has final word in resolution of conflict?	0.05	0	1	0	**0.05**
c. Role in government budgetary process	0.05	0	0	0	**0**
Subtotal 2	0.15			0.0335	**0.1**
3. Policy objective (Weight in overall index = 15%)					
a. central bank objectives	0.15	0	0.6	0	**0.09**
Subtotal 3	0.15			0	**0.09**
4. Lending to government (Weight in overall index = 50%)					
a. Limitations on advances (nonsecuritized lending)	0.18	0	0		
b. Limitations on securitized lending	0.12	0	0		
c. Who decides control of terms of lending?	0.12	0.33	0.33	0.033	**0.033**
d. Maturity of loans	0.03	0	0		
e. Restriction on interest rates on loans	0.03	0.25	0.25	0.006	**0.006**
f. Prohibition on lending in primary market	0.03	0	0		
Subtotal 4	0.5			0.039	**0.039**
Total 1+2+3+4	1			0.18[211]	**0.39**

Source: Based on Cargill, Hutchison and Itô (2000: 109)

[210] This evaluation is wrong by Cukierman, Webb and Neyapti. A value of 0.33 is more appropriate.
[211] With the corrected data from 1c the overall value is even lower (0.16).

Table 5-7 provides an updated version of Table 5-4, and views the results of the seven central bank independence indices for the Bank of Japan after the central bank Law revision. The BOJ scores higher in almost all central bank independence indices. Exceptions are the indices by Bade and Parkin (1988) and Alesina (1988, 1989). The reason behind this is that the structure of this index is very simple and the estimation in the original study was not correct. The mean value of all seven central bank independence indices increased from 0.52 to 0.68.

Table 5-7: Results of Selected Central Bank Independence Indices (before and after the BOJ Law Revision)

	BOJ 1942	**BOJ 1998**
Bade, Parkin (1988)	0.75	0.75
Alesina (1988, 1989)	0.75	0.75
Grilli, Masciandaro, Tabellini (1991)	0.38	0.63
Burdekin, Willett (1991)	0.33	0.67
Cukierman, Webb, Neyapti (1992)	0.18	0.39
Alesina, Summers (1993)	0.63	0.75
Eijffinger, Schaling (1993)	0.6	0.8
Mean Value	**0.52**	**0.68**

Source: Own calculation based on the central bank indices
Note: Numbers are in normalized values

Besides these "traditional" central bank independence indices, the issue is still discussed in the academic literature. Petursson (2000), who employ the index of Fry et al. (2000), ranks the independence of the new BOJ higher than the indices of Table 5-7, giving 9.3 points out of 10. This value is equivalent to that of the ECB (9.3), marginally higher than the Fed (9.2), and considerably higher than that of the BOE (7.7). According to Petursson's evaluation, the BOJ is almost completely goal and instrument independent. Another study was completed by Alpanda and Honig (2010). They establish a new de facto ranking of central bank independence based on the degree to which monetary policy is significantly more expansionary before elections. They rank central bank independence according to election-induced and within-country differences in money growth rates. In the 115 cross-country analysis, the BOJ comes in place 35. The

following section focuses on a recent study by Laurens et al. (2009), and critically assesses their evaluation of the Bank of Japan.

5.4.3.3 The Laurens et al. (2009) Central Bank Independence Index

A recent study by Laurens et al. (2009) constructs an index of central bank independence by combining the methodologies of two concepts: the GMT (1991) and the Cukierman (1992) index. This index is divided into political and economic independence. Political independence consists of three aspects: the appointment procedure, the relationship with the government and with constituting laws. Economic independence consists of financing public debt and monetary instruments. The data is from 2003, i.e., the result of the BOJ can be compared to the Bank of Japan Law revision ex ante and ex post (Table 5-8).

Laurens et al. (2009: 41) indicate that the BOJ has only little political independence (0.13 points on a scale from 0 to 1), the lowest of all samples. In terms of economic independence, the new Bank of Japan scores 0.75 points. In addition, they analyse whether central bank independence has improved over time (end 1980s in comparison to 2003). The result is disenchanting for the BOJ, political independence did not improve at all, and economic independence only marginally. More precisely, according to this analysis, central bank reform in Japan was not successful regarding the Bank's political independence and had only little impact on economic independence.

Table 5-8 summarizes the results for the BOJ, ECB, US Federal Reserve and BOE. This thesis finds that, regarding the Bank of Japan, there are considerable inaccuracies in the IMF study. Laurens et al. (2009) find that the political independence has not improved after the BJL revision in 1998. However, this assessment is not correct. This thesis provides a "correction" and explanation of the Bank of Japan based on the analysis in Section 4-1. Regarding point 5, the involvement of the government in the Monetary Policy Board, it is unclear why Laurens et al. (2009) give one point to the BOE, but not to the BOJ. Admittedly, this point is very difficult. In fact, until now, the Japanese government has sent representatives to all Policy Board meetings. However, this index assesses the de iure independence of central banks. The Bank of Japan Law, Article 19, Paragraph 1, states that government representatives "may, when necessary attend and express views" at Monetary Policy Meetings (*hitsuyô ni ôji, […] kaigi ni shusseki shite*).

That is, an appearance at Monetary Policy Meeting is not mandatory by law. Accordingly, the Bank of England scores one point here, because Section 13-13 of the Bank of England Act 1998 states that "A representative of the Treasury may attend, and speak at, any meeting of the Committee." Concerning the ECB, the president of the ECOFIN and commission are present (Bini-Smaghi Gros 2001: 154). As a result, the BOJ scores one point here and Laurens et al.'s (2009) evaluation is inaccurate.

Regarding point 6 of the index, the approval by the government, the Laurens et al. (2009) index gives no point for the BOJ, which is dubious. Although the Japanese government has the right to request a postponement, this request can be overruled by the Policy Board. As a result, the BOJ should receive a point here. Regarding point 8, legal protection of the central bank, the Bank of Japan Law, Article 3, states that the "Bank of Japan's autonomy regarding currency and monetary control shall be respected." Thus, again, the BOJ should receive a point here. Altogether, the BOJ scores four points, a value which is somewhat less than that of the US Federal Reserve, but higher than that scored by the Bank of England.

The second aspect of the index is economic independence. The BOJ has improved its economic independence to one point to overall six points. However, the BOJ scores lower in comparison to the ECB, US Federal Reserve, and BOE. This is due to aspects 2 and 5 of the index. Regarding providing credit to the government, there is no clause in the BJL, which defines the interest rate for the credit. Regarding the purchase of government securities, the BOJ can be forced to subscribe or underwrite government securities to a limit imposed by the Diet (Article 34). Both aspects limit the BOJ's economic independence. Here, Laurens et al.'s (2009) evaluation of the BOJ is correct.

Table 5-8: The Laurens et al. (2009) Central Bank Independence Index

	New BOJ	**New BOJ***	Old BOJ	ECB	Fed	BOE
Political Independence						
1. Appointment						
1. Governor appointed without government involvement	0	**0**	0	1	0	0
2. Governor's tenure higher than 5 years	0	**0**	0	1	0	0
3. Policy Board members appointed without government involvement	0	**0**	0	1	0	0

4. Policy Board members appointed for more than five years	0	**0**	0	1	1	0
2. Relationship with the Government						
5. Mandatory involvement of government in the Policy Board (yes=0; no=1)	0	**1**	0	1	1	1
6. Government approval is required in formulating monetary policy (yes=0; no=1)	0	**1**	0	1	1	0
3. Constituting Laws						
7. Legal obligation to pursue price stability as one of primary objectives	1	**1**	1	1	1	1
8. Legal protection for central bank in case of conflict with government (yes=1; no=0)	0	**1**	0	1	1	1
Score (1)	1	**4**	**1**	**8**	**5**	**3**
Normalized value	0.13	**0.5**	0.13	1	0.63	0.38
Economic Independence						
1. Financing of Public Deficits						
1. No automatic procedure for govt. to get credit from the central bank	1	**1**	1	1	1	1
2. Credit at market interest rate	0	**0**	0	1	1	1
3. Credit is temporary	1	**1**	1	1	1	1
4. Credit limited amount	1	**1**	0	1	1	1
5. Purchase of government securities in the primary market (yes=0; no=1)	0	**0**	1	1	1	1
2. Monetary Instruments						
6. Central bank is responsible for setting policy rate	1	**1**	1	1	1	1
7. Monitoring of the banking sector (no responsibility = 2 points; shared responsibility = 1 point)	2	**2**	1	2	1	2
Score (2)	6	**6**	**5**	**8**	**7**	**8**
Normalized value	0.75	**0.75**	0.63	1	0.88	1
Overall score (1+2)	7	**10**	**6**	**16**	**12**	**11**
Normalized value	0.44	**0.63**	0.38	1	0.75	0.69

Source: Based on Laurens et al. (2009)
Note: * own calculation

Aggregating political and economic independence, the BOJ scores ten points, or in normalized values 0.63, which is substantially higher than before the BJL revision. In comparison to other major central banks, the BOJ's independence is still lower.

5.5 Conclusion

The Bank of Japan Law revision of 1998 has improved the BOJ's legal independence significantly, and the authority of the government over the Bank was weakened in

comparison to the old BJL. However, although improvements regarding central bank independence have been implemented, the principal finding of this chapter is that the overall result of the new law is insufficient. Indeed, many articles of the Bank of Japan Law are deficient in unambiguous formulations in both the Japanese and English version. More precisely, many articles, especially Articles 4 (relationship with the government) and 19 (attendance of government representatives) do not fulfil the international standard and might be an obstruction to the conduct of independent monetary policies (see analysis in the de facto chapter). In addition, regarding a central bank's financial independence the Bank of Japan is far behind other major central banks.

The result of the BOJ Law revision can be seen in major central bank indices, in which the value of the BOJ has increased, for example in the Cukierman, Webb, and Neyapti index (1992). However, the section concerning central bank independence measurement demonstrated that the BOJ is difficult to evaluate and the results of various central bank independence indices vary extensively. Some deficiencies of the Bank of Japan Law, such as the financial dependency on the Finance Ministry (Article 51), are not covered by most central bank independence indices. A current study by Laurens et al. (2009) reveals significant inaccuracies in the evaluation of the BOJ's political independence. The independence index has been updated and corrected in this chapter.

6. CENTRAL BANK ACCOUNTABILITY AND TRANSPARENCY

6.1 Introduction

As demonstrated in previous chapters, a broad consensus among economists and policymakers has emerged that central banks should be autonomous from their governments. Following this trend, central bank statutes have been revised towards central bank independence in many countries. This trend cannot be viewed separately, and central bank independence is connected to the concept of central bank accountability and transparency, which will be analysed in this chapter.

6.2 Central Bank Accountability

6.2.1 Introduction – Democratic Legitimacy and Accountability

When discussing the issue of central bank independence, one might argue the more independence the merrier. However, it has to be noted that there is the possibility of negative side effects. Independent central banks might limit the capacity of governments to respond to economic shocks, such as a sudden rise in oil prices. In these times, governments' efforts to stabilize output and employment can be harmed by independent central banks only focussing on the goal of achieving price stability. It can be argued that the loss of flexibility in the management of monetary policy is economically and politically costly, and might exceed the benefits of independent central banks, especially if the general public is more concerned about unemployment than inflation (Briault et al. 1996: 2).

As a result, there are strong voices from government authorities and academics demanding that independent central banks should be accountable to the government. De Haan, Amtenbrink and Eijffinger (1998: 2) argue that "the basic argument for the democratic accountability of central banks is that delegation of powers to unelected officials can only be acceptable in a democratic society if central banks are one way or another accountable to democratically elected institutions." Sibert's (2009) standpoint is similar: "In a democracy, it is only acceptable to delegate power to an independent institution if that institution has legitimacy. Both formal and substantive accountability can create legitimacy." Padoa-Schioppa (2000: 29) introduces a new argument, namely the moral obligation of politicians and central banks, and states:

> "Accountability is an essential and constituent element of a democratic political order. In such an order, institutions and bodies with the power to

> affect the lives and welfare of the community must be subject to the scrutiny of the citizens or of their elected representatives. This is particularly relevant for those policy fields – such as central banking – where decisions are consciously removed from the day-to-day influences of the political arena. Thus, accountability pertains to a civic and moral obligation inherent in the political order, and is not directly related to what could be termed the "economic order"".

According to these statements, issues of democratic deficit and central bank accountability have become more relevant since the rise of central bank independence. As a result of this discussion, the majority of scholars, including Stiglitz (1998), Forder (2002), and Buiter (2008) stress the requirement for greater accountability in order to resolve the democratic deficit problem[212] of independent central banks. Before going into detail about the concept of central bank accountability, the following section attempts to provide a definition of the term accountability.

6.2.2 Definition of Accountability

Given the broad scope of the subject of accountability, it is useful to offer a definition of the term, before analysing the concept of accountability for central banks in general, and, in particular, for the Bank of Japan. In the most general sense, *Webster's New Encyclopedic Dictionary* defines 'accountability' as "an obligation or willingness to accept responsibility or to account for one's actions". A similar interpretation is presented by *The Oxford English Dictionary*, which defines accountable as "obliged to give a reckoning or explanation for one's actions; responsible." The term 'responsible' is defined as "legally or morally obliged to take care of something or to carry out a duty; liable to be blamed for loss or failure." More detailed is the explanation offered by Schedler (1999: 17), who characterizes accountability as follows: "A is accountable to B when A is obliged to inform B about A's (past or future) actions and decisions, to justify them, and to suffer punishment in the case of eventual misconduct". Schedler's definition refers to three issues of accountability. First, the central bank must provide all information that explains its actions to the ultimate principal (the general public). Second, the central bank must justify its actions. And, third, in case of failures and misconduct the principal must be able to punish the central bank. Based on Schedler's approach, Buiter (2006) distinguishes between formal and substantive accountability.

[212] The phrase "democratic deficit" is often linked to the ECB, which critics view as a central bank with a tendency of being too independent and insufficiently accountable to European citizens (e.g., Aziz: 2005; Elgie: 2002; Forder: 2002; Sibert: 2009; Follesdal and Hix: 2006; Gormley and de Haan 1996).

The former are ex-post explanations and reporting obligations, requiring a sufficient extent of openness and transparency. Hereby, the principal must be fully permitted to monitor the agent. The latter refers to consequences, including sanction measures that the principal might put on the agent in case of misconduct.[213]

According to Stiglitz (2003: 111), accountability requires three fundamentals: First, people or organisations are given clear objectives. Second, there is a consistent method of measuring whether the goals have been achieved or not. And, third, a kind of sanction measures must exist in order to punish the persons in charge if the achievement of the targets has been failed. Stiglitz argues that "the political notion of accountability corresponds closely to the economists' concepts of incentives." However, in case of a non-achievement of a/the targeted goals, it is often complicated to determine the reasons for the undesired outcome. For example, an "intervening event", such as an economic shock, may have arisen for which the agent is not responsible, or which he could not have sufficiently prevented it. Recently, the concept of accountability in monetary policy has produced a large and diverse literature among academic economists. However, an accurate and comprehensive definition is difficult to make (Lepper and Sterne 2002: 275; Huepkes, Quintyn and Taylor 2005: 33). Jabko (2009: 392) summarizes the problem of defining accountability:

> "A commonsense definition of accountability is […] demanding. A central bank can be called accountable if it can be held to account for its decisions-both in the sense of explaining its decisions and in the sense of taking responsibility for its decisions. This, in turn, requires a constituency or even perhaps a political body to which the central bank must be brought to account"

Jabko's (2009) quotation leads to the question "to whom is a central bank accountable?". Based on this question and the previous definitions, the following chapter analyses the accountability of central banks.

6.2.3 The Accountability of Central Banks

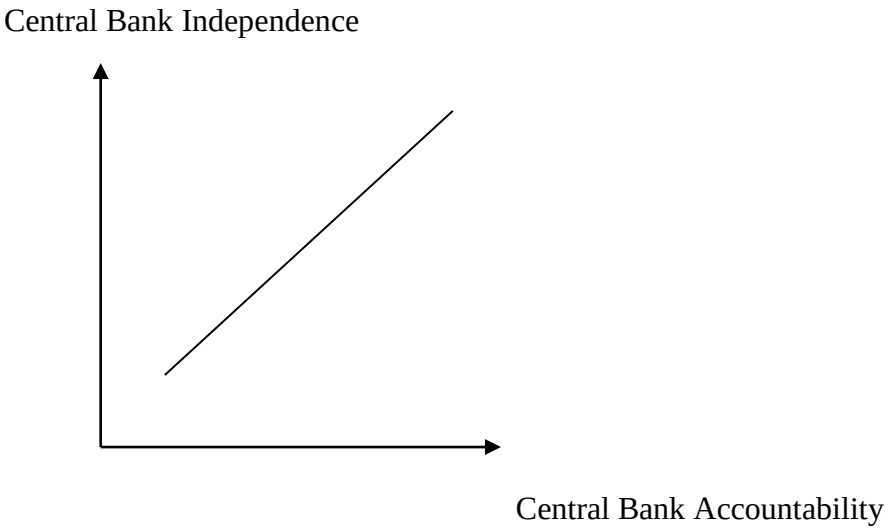
Padoa-Schioppa (2000: 29) starts his analysis of central bank accountability with the question "accountable for what? accountable to whom?" Suppose that central banks were private institutions. In this case central banks would be accountable to their

[213] Buiter (2006) argues that "central bank operational independence means absence of substantive accountability."

stockholders. However, arguably that is not the case. Rather, central banks are accountable to the principal, the general public and the government (as the representative for the public). Accordingly, Briault et al. (1996: 1-3) argue that a principal-agent relationship is the "natural context" to analyse the issue of central bank accountability.

Many scholars argue that there is a connection between central bank independence and central bank accountability (Laurens et al. 2009: 90; Eijffinger, Hoeberichts and Schaling 2000). Lybek and Morris (2004: 4, italics added) emphasize the role of accountability for central banks: "Central bank autonomy *and accountability* are now generally accepted as the best way to achieve and maintain price stability". Altogether, formal mechanisms of accountability requirements imposed by the government reduce the negative effects of asymmetric information (uncertain preferences of the central bank). Based on this assumption, Grauwe and Gros (2008: 32) provide a simple model of the correlation between central bank independence and accountability (Figure 6-1). The development towards greater central bank independence is directly related and complementary to the concept of accountability. The concept of accountability can be understood as a counterbalance to enhanced independence[214] (Laurens et al. 2009: 90; Eijffinger, Hoeberichts and Schaling 2000; Sterne 2000: 99).

Figure 6-1: Central Bank Independence and Accountability



[214] Coined slightly differently, "greater accountability is the government's *quid pro quo* for granting greater central bank autonomy." (Briault et al. 1996: 1).

Source: Based on Grauwe and Gros (2008: 32).

One important question is whether or not central bank independence is directly linked to accountability. The literature is split in this issue. Some scholars find a positive correlation between accountability and independence (for instance, Bini-Smaghi and Gros (2001), and Frisell, Roszbach and Spagnolo (2008)). Hughes Hallett and Libich (2006) construct a monetary policy game with three institutional features: independence, accountability and transparency. They emphasize synergies and trade-offs between accountability and independence. On the other hand, Masciandaro, Quintyn and Taylor (2007) demonstrate that the independence of central banks is not perfectly linked to accountability. Correspondingly, Sterne's (2000: 89, 101-102) cross-county analysis of 94 central banks does not show any significant correlation between independence and accountability. Some countries have central banks with very high degrees of independence and with limited accountability, while many other central banks enjoy both high levels of independence and accountability.[215] Grauwe and Gros (2008: 30-31) comment that the "lack of relationship between accountability and independence across countries may be due to the fact that the relation between accountability and independence may be influenced by social and political factors." Hüpkes et al. (2005: 8) add the problem of legitimacy of independent organisations and argue that the relationship between central bank independence and accountability can be explained with the concept of complementarities:

> "accountability generates legitimacy, and legitimacy supports independence, it becomes clear that the relationship between accountability and independence does not imply a trade-off, but is one of complementarities […] good accountability arrangements make independence effective because they provide legitimacy to the independent agency."

In order to gain a deeper understanding of the concept of central bank accountability, one has to distinguish the term in more detail. The following sections distinguish between ex ante and ex post, and additionally between de iure and de facto accountability.

[215] For instance, Canada, Mexico, New Zealand, and Sweden (Sterne 2000: 102).

6.2.4 Different Types of Accountability

Accountability can be divided into two different types, namely ex ante and ex post accountability. Ex ante control is the principal's (government or parliament) right to give instructions and tasks to the central bank, including rules, principles and standards. Additionally, ex ante accountability is the central bank's obligation to report to the principal before monetary policy action is taken. The central bank must provide forecasts for relevant macroeconomic data and "justify deviations of forecast values from target values".[216] In contrast, ex post accountability is the central bank's obligation to report after monetary policy decisions have been made, including publications whether or to what extent it has been able to achieve its monetary policy objectives and to report before the parliament on a regular basis to explain its monetary policy decisions (Bini-Smaghi and Gros 2001; Bofinger et al. 2001: 221-222; Hüpkes et al. 2005: 19).

Another possible distinction can be made between de iure and de facto accountability. De iure accountability requires a formal contract between the central bank and the government, which must be manifested in the central bank law. It is hereby it is essential "to specify not only the object of the responsibility, but also statements about assumption of responsibility, the reporting duties of the central bank, and punishment in case of failure". De facto accountability goes beyond the legal provisions issued in the central bank law. In the centre is the central bank's willingness to be accountable, and to explain monetary policy decisions and actions (Laurens et al. 2009: 94; Grauwe and Gros 2008: 20). Briault et al. (1996: 67) refer to transparency and information by deeds (words) when they talk about de facto accountability. These words include speeches, press statements, appearances before parliament by central bank staff, inflation reports, and the publication of minutes of monetary policy meetings. As a result, the concept of transparency is one essential feature of de facto accountability.

[216] In reality, ex ante accountability is difficult for the central bank since it depends solely on forecasts. As a consequence there are doubts of the efficiency of ex ante accountability. For instance, former ECB president Duisenberg stated that "the publication of the forecasts cannot contribute to accountability. Rather, its performance in maintaining price stability in the medium term should be used by the public to judge the success […]" (Duisenberg 1999: 4).

The issue of central bank transparency is the subject of the following section. After analysing different aspects of central bank transparency, current transparency practices - both formal and informal - will be considered.

6.3 Central Bank Transparency

6.3.1 Introduction

A growing body of contemporary research has focused on the issue of transparency of central banks. Transparency is commonly regarded as one important aspect of accountability. In the past central banks had been surrounded by an aura of metaphysical approaches, and some authors characterized central banking with terms such as "mystique" or as an "esoteric art" (Brunner 1981: 5; Goodfriend 1986: 63-64). Times have changed and, at present, a broad consensus among academics and central bankers has emerged that sophisticated transparency arrangements is an obligation when creating an independent central bank which, finally, lead to benefits for both the central bank and the public (Issing 1999: 66). Before analysing the issue of transparency, including central bank transparency measures, in more detail, it is necessary to gain a better understanding by trying to provide a definition of the term of transparency.

6.3.2 Definition of Transparency

Unfortunately, there is no "universally accepted definition of central bank transparency" (Chortareas, Stasavage, and Sterne 2002: 99), and it is a term which is particularly difficult to define (Winkler 2000). Webster's English dictionary defines the term 'transparent' as "easily understood or seen through". In the context of monetary policy, transparency can be broadly defined as the extent to which central banks disclose information related to the monetary policymaking process. Ferguson (2001) defines transparency as "the openness of a central bank in stating its monetary policy decision and explaining the reasoning behind them". The move towards greater levels of transparency is one subject of Blinder's (2004) "Quiet Revolution" in central banking. Emphasizing the role of the public, Blinder (2004) argues that central bank information should be clear, have sound contents and be open to the public. The German Bundesbank (2000: 17) views transparency as a commitment by the central bank, stating that "[t]ransparency […] plays the part of self-imposed commitment: by disclosing the basis of the policy decisions, the central bank enables the general public to assess their adequacy."

6.3.3 The Transparency of Central Banks

Since the 1990s, numerous central banks have increased the transparency regarding objectives, monetary policy procedures, monetary policy explanations, models and forecasts. The general trend towards enhanced transparency since the late 1990s was commented by Dincer and Eichengreen (2007: 1) as follows: "greater transparency in central bank operations is the most dramatic change in the conduct of monetary policy in recent years". To comment the current trend towards more transparent central banks, it is useful to take the words of Alan Greenspan, US Federal Reserve Chairman between 1987 and 2006, into account. In a 1987 testimony Greenspan stated that "since I have become a central banker I have learned to mumble with great incoherence. I seem unduly clear to you, you must have misunderstood what I said."[217] This is in line with the "never explain, never excuse" attitude by the former Bank of England Governor Montagnu Norman (Yellen 2013). However, 15 years later, in 2002 at a conference on transparency, Greenspan (2002: 6) stated the complete opposite: "Openness is an obligation of a central bank in a free and democratic society."[218]

How can this trend towards more central bank transparency be explained? It can be argued that there is a common sense of the advantages of greater central bank transparency (IMF 1999; BIS 1999, 2009). The Central Bank Governance Group of the Bank for International Settlements (BIS) argues that transparency of monetary policy is considered as beneficial for both the principal and the agent. It leads to a decrease of asymmetric information between the central bank and the public which reduces macroeconomic uncertainty (BIS 2009: 145-146). Another important factor is the promotion of central bank transparency by influential international organisations such as the abovementioned BIS and IMF. Both institutions have published papers (e.g. IMF 1999; BIS 1999, 2009) to encourage discussion on central bank transparency and to develop a common framework for central bank transparency, including the central bank's policy objectives, operating targets, reaction functions and the decision-making process.

[217] Quoted from Geraats (2007: 37).
[218] Quoted from Cukierman (2005: 25).

The economic literature suggests two benefits of central bank transparency. First, empirical studies have found that enhanced transparency has led to an increase of predictability of monetary policy decisions and, therefore, to an increase in private sector forecast accuracy, stabilising inflation expectations. And second, transparency in monetary policy has reduced the average level and the variability of inflation, while additionally lowering the output variability (Carpenter 2004; Dincer and Eichengreen 2007).[219]

Central bank transparency has become the issue of intense academic debates. One line of argumentation in the academic literature analyses the economic consequences of greater transparency on the conduct of monetary policy. An influential precursor to the early transparency literature is the seminal paper by Cukierman and Meltzer (1986), who analyse the optimal degree of ambiguity in monetary policy. Faust and Svensson (2001) extend the model by distinguishing between imperfect monetary control and operational transparency. As a consequence of the debate, it can not necessarily be argued that the more central bank transparency the merrier. For instance, Blinder (2004) warns that monetary policy decision-making cannot be performed completely open. Blinder discourages from too much transparency as, for example, the decision to publish transcripts bears the risk that certain members may refrain from speaking candidly in the meetings. In particular, practising central bankers have a cautious stance towards too much transparency. For instance, former US Federal Reserve Governor Alan Greenspan argues critically in regards of too much transparency.[220] Another example is Otmar Issing, former Chief Economist of the ECB, who argues that:

> "[i]t is not quite obvious to my mind that the legitimate and important cause of transparency would be advanced if central banks were to make available to the public the maximum amount of information at their disposal […] Moreover, could the public ever be sure that some important information was not withheld, some ulterior motives hidden, some decisions not revealed?" Issing (1999b, Speech 28 January 1999)

[219] Laurens et al. (2009: 108-111) present eight aspects that build the rationale towards enhanced transparency: 1. increase central bank credibility, 2. influence of expectations, 3. protect the independence of central banks, 4. strengthen the understanding of monetary policy, 5. reduction of information asymmetries and uncertainty in financial markets, 6. enhance market efficiency, 7. reduction of government uncertainty on monetary policy performance, and 8. enhance fiscal and monetary policy coordination

[220] See, the commentary of Alan Greenspan in Capie et al. (1994: 253).

This quote shows that critical voices warn against unlimited transparency. However, in spite of these arguments, the majority of academics and central bankers argue in favour of central bank transparency. In order to understand the concept of central bank transparency better, it is necessary to go into more detail. The following section focuses on the relationship between transparency and accountability.

6.3.4 Transparency versus Accountability

Regarding the relationship between central bank accountability and transparency, the Central Bank Governance Group of the Bank for International Settlements (BIS) states that:

> "For the purpose of de iure accountability, central banks are generally subject to some disclosure requirements. But the transparency of many central banks nowadays goes far beyond these mandatory information disclosures. The current practices and trends in central bank transparency greatly contribute to de facto accountability. As a result, central bank accountability and transparency are intrinsically related." (BIS 2009: 144)

In the economic literature, it is commonplace that transparency is a part of accountability problems (e.g., Briault et al. 1996; Grauwe and Gros 2008). However, Castellani (2002: 4) argues that the traditional "accountability through transparency" approach is incomplete: "Contributions, focusing on transparency as a precondition for holding the monetary authority responsible for its policy-making, abstract from a formal conceptualisation of accountability. Most of them miss to distinguish accountability and transparency in a clear way." According to Issing (1999b), the difference between accountability and transparency is that accountability has to take into account the "deeds" of the central bankers, whereas transparency focuses on the communication strategy with the applied "words". The ensuing section refers to these "words" by providing information about publications of a central bank.

6.3.5 Publications and Communication

One important aspect of central bank transparency is communication with the government, parliament, general public and financial markets. The provision of valuable information regarding the future course of monetary policy can be accomplished through the publication of minutes of monetary policy committee meetings and forecasts. In publishing valuable information, central banks offer insight into how they

view the economy, and explain its monetary policy decisions, which may enhance, and protect a central bank's independence.

Many scholars consider the publication of minutes of the monetary policy committee meetings as an essential source of information (Blinder et al. 2008; Buiter 1999; Kohn and Sack 2004; Svensson 2000). The publication of the individual voting behaviour of the members is useful information for the estimation of the future strategy of interest rates.[221] In addition, macroeconomic forecasts are another important aspect of publications and a part of economic transparency (see definition in the following section). However, Geraats (2001) finds that forecasts concerning economic shocks taken by central banks are not better than those of organizations, such as the IMF, OECD, and national and private research institutes, and that central bank forecasts eliminate the information asymmetry of economic shocks. To lend some support to this finding, Issing (1999a: 507) states that:

> "I am rather sympathetic to the view that central banks have only limited information advantage over sophisticated market participants, both with respect to the available data and-perhaps-also with respect to the understanding how the economy works. Central banks should not endeavour to maintain or even create any such information asymmetry, nor should they pretend that they have some superior or magical insights"

According to Bofinger et al. (2001: 224), the central bank's only information advantage implies the "knowledge about the intended path of short-term interest rates". In contrast to these arguments, Romer and Romer (2000) find that central banks have an information advantage, and that forecasts made by the US Federal Reserve about inflation (BIP deflator) are superior to those of commercial forecasters.

6.3.6 Different Types of Transparency

Eijffinger and Geraats (2006) define transparency as the level of disclosure of information related to the monetary policy decision-making process. As this is a complex subject it is necessary to differentiate the term transparency further. In accordance with Geraats' (2001) terminology, transparency can be classified into five different types:

[221] Bofinger et al. (2001: 228), however, points out that highly controversial issues are rather discussed informally and not in the Monetary Policy Meetings and argues that there is no empirical evidence that central banks with a intensive information strategy performs better than central banks which provide only fractions of possible information.

1. Political Transparency
2. Economic Transparency
3. Procedural Transparency
4. Policy Transparency
5. Operational Transparency

Political transparency refers to the degree of openness and clearness of arrangements of the central bank's objectives. This demands an explicit statement and a formal definition of the objectives on monetary policy, including an unambiguous prioritization in the case of conflicting goals and quantitative targets. Political transparency is enhanced by explicit institutional arrangements, such as central bank independence, central bank contracts and explicit override mechanisms of the government. Clearly defined arrangements help to avoid excessive influence of politicians, which can endanger the formal goal of the central bank. [222] [223]

Economic transparency refers to the disclosure of economic information regarding monetary policy. This includes all information the central bank applies to conduct monetary policy. The publication of forecasts is an important feature of economic transparency. The public can build its own forecasts based on the information provided by the central bank. Another aspect is the employment of policy models to forecast economic determinants (inflation, economic growth). Geraats (2001) argue that the publication of central bank forecasts reduces the inflation bias and provides the central bank with enhanced flexibility to stabilize the economy.

Procedural transparency concentrates on the method of making monetary policy decisions. The most important feature is the publication of minutes of Monetary Policy Board Meetings, which allow the public to observe the decision-making process of monetary policy. It should include the provision of an explicit monetary policy rule or strategy that explains the monetary policy framework, the way monetary policy decisions are achieved and, preferably, individual voting records. Gersbach and Hahn

[222] It has to be noted that political transparency does not necessarily need to be under control of the central bank. It is often determined by the government or legislature (political authorities).
[223] It is striking that inflation targeting central banks score the maximum value of political independency. However, inflation targeting is not a necessary condition for political independence as the example of the ECB shows (Eijffinger and Geraats 2006).

(2004) demonstrate that voting transparency is beneficial in the case of different preferences of the central bank in regards of socially optimal objective. In contrast, in the case of differing degrees of competency of central bankers, the publication of voting records might be damaging (Gersbach and Hahn 2008).

Policy transparency asks in what time horizon monetary policy decisions are announced. An immediate announcement to inform economic agents is clearly preferred. Preferably, it consists of explanations of the decision and a policy indication of future monetary policy actions. Operational transparency refers to the conduct of the central bank's monetary policy actions, including analyses of past errors when aiming to accomplish the operating targets of monetary policy and an announcement of reasons in case of divergences between the target and the achieved results, such as macroeconomic disturbances and unanticipated shocks that influence the transmission of monetary policy. Jensen (2001) argues that enhanced operational independence is beneficial in case of low credibility of central banks. Table 6-1 summarizes the characteristics of each aspect of transparency.

Table 6-1: Aspects of Central Bank Transparency

Aspects of Transparency	Characteristics
Political	Formal objective Quantitative targets Institutional arrangements
Economic	Economic data Policy models central bank forecasts
Procedural	Explicit strategy Minutes Voting records
Policy	Prompt announcement Policy explanations Policy inclination
Operational	Control errors Transmission disturbances Evaluation policy outcome

Source: Eijffinger and Geraats (2006)

Having provided with background knowledge of the terms and concepts of central bank accountability and transparency, the analysis will now focus on the Bank of Japan's accountability and transparency.

6.4 The Accountability and Transparency of the Bank of Japan

A key question is to what extent are requirements concerning accountability and transparency manifested in the Bank of Japan Law from 1998. Most important is Article 3, Paragraph 2 of the BJL, which claims that the BOJ is obliged to "clarify to the public the content of its decisions, as well as its decision making process, regarding currency and monetary control". Other obligations of accountability in the new BJL are the following:

> 1. A summary of the Policy Board meetings including the decisions on monetary policy have to be published after a specific period of time decided by the Board (Article 20). A disclosure of the complete transcripts (*gijiroku*) of the Policy Board meetings (Article 20, Paragraph 2) follows after an appropriate amount of time.[224]
>
> 2. Approximately every six months the Bank is compelled to submit a report on the Bank's decisions through the Minister of Finance to the Diet. In addition, the central bank's Governor[225] or a representative have to appear before the Diet on request in order to explain the Bank's operations (Article 54).
>
> 3. Regarding the conduct of personal financial affairs, the salaries of BOJ executives and staff (Article 31) and rules concerning the obligation to separate themselves from private enterprises (Article 32) are required to make public in order to avoid conflicts of interests.

6.4.1 The Bank of Japan's Self-Conception of Accountability

The Bank of Japan's statements about accountability are mostly restricted to issues regarding transparency. Statements concerning the BOJ's relationship to the government are missing. One reason for this is a different understanding of the term 'accountability' in Japan. Former BOJ Governor Matsushita (1996), for instance, describes the Japanese approach to the term of accountability as follows:

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[224] In practice, the BOJ publishes the transcripts after ten years (in Japanese).

[225] In detail the Law claims that "the Governor, the Chairman of the Policy Board or a representative designated by them […]". In practice, the Governor acts usually as the chairman.

> “the word "accountability“ is not familiar to the Japanese […]. The word ‘accountability’ is commonly translated into a Japanese word meaning ‘responsibility.’ However, this translation does not fully reflect the true meaning of the word. The word “accountability” derives from ‘account’, which has such meanings as to count money or to explain. In other words, ‘accountability’ implies not simply responsibility but ‘responsibility to explain properly’. Unfortunately, there is no corresponding Japanese word. This may be an indication of the fact that the concept of this word was not recognized widely in Japan. Yet, it is an indispensable concept when discussing central bank independence.”

Indeed, the Japanese term for accountability is *setsumei sekinin* (Bank of Japan 1996, 2000b; Gotô 1998), which is not a precise replacement of the term ‘accountability’. In spite of a clear definition what exactly the term accountability means, the BOJ already began to improve its accountability even before the revision of the BOJ law. For instance, in 1995, the BOJ started to announce all relevant changes in its open market operations, including a basic thinking behind such changes and its immediate policy actions regarding money market rates. Furthermore, in regards of changing the official discount rate, the BOJ has provided “in official statements a more detailed explanation than before on the Bank's economic outlook and the reasoning behind the policy change.” In addition, from 1996 on, the BOJ has upgraded the contents of the Policy Board’s monthly and annual reports, including details and explanations of monetary policy decisions (Matsushita 1996).

Table 6-2 offers a selection of statements made by the BOJ concerning accountability. These statements made by BOJ staff or recorded in BOJ official documents demonstrate that the concept of accountability is considered similar to the academic approach presented in the sections before. Furthermore, the BOJ is continuously working on making progress in explaining its viewpoint on policy and business operations in order to increase accountability (Bank of Japan 2004: 18). However, more specific statements about accountability which exceed the claim of enhanced transparency, for instance the role of the government and possible sanction measures, are completely missing.

Table 6-2: Selection of Statements by the Bank of Japan Regarding Central Bank Accountability

Statement	Statement
Deputy Governor Yamaguchi (1999)	“naturally, the independence of monetary policy must be underpinned by accountability. In this regard, we should make continuous efforts in explaining our thinking on monetary

	policy, on whatever occasions available, in easy-to-understand terms, so as to gain the understanding of the public”
BOJ document (BOJ – Outline of monetary policy)[226]	”It is very important to present the Bank's basic thinking on the conduct of monetary policy and evaluation of the developments of the economy and prices in a timely and lucid manner, from the viewpoint of fulfilling the Bank's accountability to the public.”
Shiratsuka (2001: 65)	“accountability of a central bank is ensured by its obligation to give a convincing rationale for its policy conduct, especially in the case of missing a previously announced target”.
The Bank of Japan (2002)	“accountability for the conduct of monetary policy and other responsibilities assigned to the central bank should be specified in legislation.”
Deputy Governor Iwata (2008)	“[…] at the same time, in a democratic society, the responsibility to fulfil the mandate of policy objectives is increased; that is to say, this independence is accompanied by accountability. A lack of transparency in the decision-making process may easily lead to a deficit of accountability.”

Source: Own compilation based on documents by the Bank of Japan

Additionally, Fujiwara (1998) offers insights about a somewhat irritating approach of accountability proposed by Hayami, BOJ Governor from 1998 to 2003. Hayami, known as a devout Christian, explained that the real meaning of accountability refers to the “Last Judgement” (*saigo no shinpan*) and how one is accountable for oneself. The emphasis of personal accountability and conscience (*ningen no ryôshin*) before the Christian God is a somewhat dubious approach by a Governor of a central bank. However, Hayami’s approach of accountability might help to explain his behaviour of vigorously following his own approach (see, case studies in Chapter 8).

Anoter issue is ethical discipline. In 1998 the Bank of Japan published documents such as the “Rules Regarding Ethical Discipline” and a “Code of Conduct for the Bank Executives and Staff”, in order to establish an ethical behaviour standard for BOJ officials. The former is a code of conduct for Bank of Japan executives and staff, which was decided upon the Policy Board in accordance with Article 32 of the BJL. It claims that BOJ officials must carry out their duties under the highest amount of responsibility, and requires BOJ executives and staff to “understand the public mission of the Bank of Japan and endeavor to discharge duties efficiently and with an emphasis on fairness”

[226] http://www.boj.or.jp/en/mopo/outline/

(Article 2). Additionally, the rules describe confidentiality obligations (Article 6), restrictions on concurrent employment (Article 7), and include comments regarding external activities (Article 9). The latter, "Code of Conduct for the Bank Executives and Staff", was published by the Policy Board on 6 March 1998, and provides detailed ethical standards and prohibitions for external activities, including information disclosure, standards for speeches, prohibition on dining, gifts, reception of special treatment, activities for personal profit and restrictions on outside business and employment after retirement (Bank of Japan 2002c: 20).

6.4.2 The Bank of Japan and Price Stability

A clear central bank objective is an important feature of accountability (De Haan, Amtenbrink and Eijffinger 1998). It can be argued that the 1998 Bank of Japan Law requires the Bank to take responsibility for defining the term price stability in a clear way. However, for quite a long time the BOJ preferred to remain vague about a definition of price stability, for instance to quantify the term. In a report published in October of 2000, the Bank stated that there is no consensus in the Policy Board regarding a clear definition of price stability. Policy Board members explained this with the argument that a severe economic environment with deflationary tendencies interest rates near zero. The belief that it is too complicated to provide a clear definition of price stability was dominant in the BOJ (Bank of Japan 2000a). It seems that the BOJ was concerned that a failure to achieve a precise monetary policy goal may harm the Bank's credibility and reputation.

Since March 2006, the BOJ releases "The Bank's Thinking on Price Stability" [227] on an annual basis, which provides some guidance in quantitative targets.[228] Minegishi and Cournede (2009: 38) remark that this document is based on the view of the Policy Board members,[229] and, thus, strictly speaking, is not the policy target of the BOJ. In the edition published in March 2006 following is stated:

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[227] Bank of Japan, "The Bank's Thinking on Price Stability," Bank of Japan Quarterly Bulletin, 14 (2), 2006, pp. 65–90 (available at http://www.boj.or.jp//en/type/release/zuiji_new/mpo0603a.htm).
[228] The plan to issue the Bank's thinking on price stability was already discussed in the Monetary Policy Meeting on March 2000. In October the same year the BOJ released a document "On price stability".
[229] "The Bank of Japan will review its basic thinking on price stability, and disclose a level of inflation rate that its Policy Board members currently understand as price stability from a medium- to long-term viewpoint, in their conduct of monetary policy. Board members will conduct monetary policy in the light of such thinking and understanding" (BOJ 2006: 44, Annual Review 2006).

> "by making use of the rate of year-on-year change in the consumer price index to describe the understanding, an *approximate range between zero and two per cent* was generally consistent with the distribution of each Board member's understanding of medium- to long-term price stability." (Bank of Japan 2006, italics added)

The given quantitative range of the target between zero and two per cent is quite broad, and, thus, it is possible to doubt a large practical benefit. It is not clear which price index the BOJ employs to judge whether or not price stability has been achieved. For instance, the Bank of Japan does not unmistakably state whether or not price stability includes asset prices. In other words, the BOJ fails to provide an explicit monetary policy goal. The Bank of Japan's definition of price stability is unclear in comparison to that of the ECB or Swiss National Bank, which have an explicit and clear monetary policy objective. Basically, the BOJ preferred to take a cautious stance towards defining a clear monetary policy objective. The reason behind this is that the BOJ's definition of price stability is performed by each Policy Board member separately (Blinder et al. 2001: 79-81; Minegishi and Cournede 2009). This means that the understanding of price stability may change if new Policy Board members enter the Board, or if a member changes his policy stance. This procedure implies that the government can impose much more influence on the Bank of Japan by choosing members that have an understanding of price stability that is close to that of the government. Recently, the BOJ has changed its policy goals. Since February 2012, the BOJ has introduced an inflation target of one per cent (For details, see Bank of Japan 2012, Minutes 13-14 February 2012). Table 6-3 summarizes selected statements by the Bank of Japan regarding the subject of price stability.

Table 6-3: Selection of Statements by the Bank of Japan Regarding the Understanding of Price Stability

Time	Source	Statement
27 May 1994	Principles for the Conduct and the Goal of Monetary Policy (Speech made by Governor Mieno)	"One of main goals of monetary policy is delivering '**sustainable growth without inflation**' in the medium- to long-run. […] The question is often posed on which price indicator, the Consumer Price Index or the Wholesale Price Index, the definition of price stability should be based. However, it is inappropriate to single out a price indicator, as the goal of monetary policy is the 'stability of prices' not 'stability of a price index.'"

11 October 1996	Financial Innovation, Financial Market Globalization, and Monetary Policy Management (Speech made by Governor Matsushita)	"The Bank of Japan [...] intends to manage monetary policy appropriately with the aim of maintaining price stability, **preventing inflation or deflation of domestic prices**."
27 June 1997	A New Framework of Monetary Policy under the New Bank of Japan Law (Speech made by Governor Matsushita)	"It is, however, not easy to define price stability. There are diverse types of price indicators: for example, the Consumer Price Index, Wholesale Price Indexes, and the GDP deflator. Each of these has its limitation, such as the range of items covered or the timing of release. Further, many studies have been conducted more recently on the possibility that these indicators offer a substantially biased measurement of prices."
13 October 2000	On Price Stability	"[I]t is not deemed appropriate to define price stability by numerical values. […] **Price stability, a situation neither inflationary nor deflationary**, can be conceptually defined as an environment where economic agents including households and firms can make decisions regarding such economic activity as consumption and investment without being concerned about the fluctuation of the general price level."
9 March 2006	The Introduction of a New Framework for the Conduct of Monetary Policy	"Price stability is a state where various economic agents including households and firms may make decisions regarding such economic activities as consumption and investments without being concerned about the fluctuations in the general price level. […] Price stability is, conceptually, a state where the change in the price index without measurement bias is zero per cent."
9 March 2006	An Understanding of Medium- to Long-term Price Stability	"It was agreed that, by making use of the rate of year-on year change in the consumer price index to describe the understanding, an approximate range between **zero and two per cent** was generally consistent with the distribution of each Board member's understanding of medium- to long-term price stability. Most Board members' median figures fell on both sides of one per cent."
27 April 2007	Outlook for Economic Activity and Prices	"The 'understanding' expressed in terms of the year-on-year rate of change in the CPI, takes the form of a **range approximately between 0 and 2 per cent**, with most Policy Board members' median figures falling on one side or the other of 1 per cent."
18	Clarification of the	"**In a positive range of 2 per cent or lower,** and

December 2009	`Understanding of Medium- to Long Term Price Stability'	the mid points of most Policy Board members' understanding' are around 1 per cent."
14 February 2012	The Price Stability Goal in the Medium to Long Term	"The Bank judges that 'the price stability goal in the medium to long term' is in a positive range of 2 per cent or lower in terms of the year-on-year rate of change in the consumer price index (CPI) and, more specifically, **set a goal at 1 per cent for the time being**."

Source: Based on Nishizaki, Sekine, and Ueno (2012: 15-16), italics added.

6.4.3 The Transparency of the Bank of Japan

In comparison to the old BOJ Law, the revision of the BOJ Law has increased the transparency to a substantial amount (Uekusa 1999, Mikitani and Kuwayama 1999). The transparency of the Bank of Japan can be distinguished into three aspects: transparency to the public, transparency to the government and transparency to the Diet or State (The Bank of Japan 2002c; Kanegae and Senda 2005: 18-19).

1. Transparency to the public

1. The BOJ must clarify the contents of its decisions to the public (Article 3, Paragraph 2)
2. After each Policy Board meeting the BOJ shall publish a document which contains an outline of its decisions (Article 20, Paragraph 1)
3. Publication of complete transcripts after a appropriate amount of time (Article 20, Paragraph 2)
4. The BOJ shall make available financial statements (Article 52, Paragraph 3)

2. Transparency to the government

1. The BOJ must maintain always close contact and exchange views with the government (Article 4)
2. The BOJ must submit results of on-site examinations on request (Article 44, Paragraph 3)
3. A budget plan has to be submitted to the MOF every fiscal year for authorization (Article 51)

4. The BOJ shall report illegal activities of BOJ staff to the Finance or Prime Minister (Article 56)
5. The Bank must prepare reports about its business operations on request of the Prime Minister of Minister of Finance (Article 58)

3. Transparency to the Diet

1. the BOJ must prepare and submit a report to the Diet approximately every six month (Article 54, Paragraph 1) (the so-called "Semiannual Report on Currency and Monetary Control") and explain it to the Diet (Article 54, Paragraph 2)
2. The Governor or a representative must attend to the Diet on request (Article 54, Paragraph 3)

Kanegae (2007: 2-8) critically raises the question if the responsibility to explain the monetary policy decisions is guaranteed in a sufficient way through the above-listed paragraphs of the Bank of Japan Law. Indeed, in practice, it seems that the BOJ acts cautiously in regards of providing too much transparency. For instance, in 1998, the BOJ was aware that a vast amount of financial institutions were facing difficulties, but refrained from reporting it to the public. Ueda Kazuo, Policy Board member from 1998 to 2005, argued that if the BOJ had published its information, the problem would have deteriorated.[230] Ueda's stance is similar to that of other economists previously mentioned in this chapter on criticisms of too much central bank transparency, arguing that it is not always optimal for a central bank to reveal all of its information.

6.4.4 The Bank of Japan's Transparency in Practice

After having identified the BOJ's transparency de iure, the following analysis covers transparency arrangements and improvements in practice. Blinder et al. (2001: 81) argue that the difficult economic situation in Japan since the beginning of the new millennium has directed the BOJ towards more transparency in order to "pre-empt political attacks on its legitimacy and independency."

[230] Comments by Ueda in Blinder et al. (2001: 108).

The Bank of Japan's Publications

As seen in a previous section, publications are a major issue of the transparency of a central bank. After the BOJ was granted independence, the central bank made first efforts to exercise its independence and transparency through the expansion of publications on its webpage. The BOJ offered a variety of informative data and detailed accounts of the monetary policy board meetings. The Bank of Japan publishes a high amount of information with following aims:

1. To enhance transparency
2. To provide precise and reliable data that adequately reflects changes in economic and financial structures
3. To respond to the changing needs of users
4. To improve the compilation of statistics

First and foremost are publications regarding the meetings of the Policy Board, including announcements of decisions (*kettei naiyô*) and the publication of minutes (*yôshi*). The Bank of Japan is one of the central banks which even publish the entire transcripts (*gijiroku*) of the Board meetings.

The BOJ publishes a variety of monetary and financial statistics, including the corporate goods price index (CGPI), changes in the money stock (M2+CDs) and credit, the amount of outstanding deposits by depositor, the loans and discounts outstanding by sector, and the balance of payments statistics.[231] In addition, the Bank of Japan gathers survey data in form of the "Short-Term Economic Survey of Enterprises in Japan" (*nichgin tanki keizai kansoku*; short: *tankan*) (Table 6-4) and, since 1993, the "Opinion Survey on the General Public's Views and Behavior" (*seikatsu ishiki ni kan suru ankêto chôsa*), which surveys how the public's impression is affected by changes in financial and economic conditions. Since 2002, the BOJ has started to publish data on the "amount outstanding of collateral" accepted by the BOJ, the amount of JGSs held by the BOJ, and data about its purchases of stocks (Bank of Japan 2003: 16-17, Annual Review 2003).

[231] This is entrusted by the Ministry of Finance to the Bank of Japan.

The Bank of Japan conducts research on economic and financial conditions, as well as the financial system and financial markets, and publishes various reports, including the Monthly Report of Recent Economic and Financial Developments. Further information is provided in the Bank of Japan Quarterly Bulletin, Outline of Business Operations, and the Annual Review. Additionally, the BOJ publishes various research papers, including the Monetary and Economic Studies and the IMES discussion paper series. Table 6-4 provides a summary of the BOJ's major publications, which comprises the frequency and contents.

Table 6-4: Major Publications of the Bank of Japan

Title	Frequency of Publication	Contents
Announcements of MPM decisions (*kettei naiyô*)	after each MPM (1-2x month)	monetary policy decisions, including guidelines for money market operations and changes in the official discount rate
Minutes of MPM's (*yôshi*)	after each meeting	Summary of discussions of MPM.
Transcripts of MPM's (*gijiroku*)	10 yrs. after the meetings	The entire transcript of each MPM.
Monthly Report of Recent Economic and Financial Developments (*kinyû keizai geppô*)	monthly	Analyses of the economic and financial developments on which decisions on money market operations are based. Consists of "The Bank's View" and "The Background"
Outlook for Economic Activity and Prices[232] (*keizai bukka jôsei no tenbô*)	2x year (April and October)	Part of the monthly report. Policy member's forecast of real GDP, domestic wholesale price index, CPI
Semi-annual Report on Currency and Monetary Control (*tsûka oyobi kinyû no chôsetsu ni kan suru hôkoku sho*)*	2x year	Report to the Diet on the Bank's monetary policy (Art. 54 of the BOJ Law) Contains decisions of Monetary Policy Meetings and operations by the BOJ
Outline of Business Operations for Fiscal XXXX (*gyômu gaikyô sho*)	annually	Outline of the Bank's business operations in each fiscal period as specified in Article 55
Annual Review	annually	Review of monetary and economic developments. Outline of Bank's organisation. Financial statements
Tankan (*nichgin tanki keizai kansoku*)	quarterly	Short-term economic survey of enterprises
Monetary and Economic Studies	annually	Monetary and Economic Studies is published by the Bank of Japan's

[232] Before April 2004 the English title was "*Outlook for Risk Assessment of the Economy and Prices*".

		Institute for Monetary and Economic Studies (IMES). The publication seeks to provide information on monetary and economic issues to the general public
IMES Discussion Paper Series	Various issues per year	IMES Discussion Paper Series is circulated in order to stimulate discussion and comments

Source: Bank of Japan (2004): 19-20; Bank of Japan and IMES webpage.
Note: *available only in Japanese; summary available in English.

Press Conferences

For some central banks, including the BOJ, press conferences are an integral part of the Monetary Policy Meetings. Press conferences, usually held by the Governor, are mandatory once a month. Most important for transparency is that the BOJ holds a press conference after the Monetary Policy Meeting, in case of changes in the monetary policy guideline. The Governor, in the position as chair of the Policy Board, explains why these changes had been decided by the Bank. Subsequently, a question and answer session with Journalists follows. This information is made available to the public in form of summaries on the Bank of Japan website on the following business day (Bank of Japan 2002c: 11). Since October 2003, the BOJ has increased its transparency by holding a press conference after every Monetary Policy Meeting, even when the monetary policy remains unchanged.

Monetary Policy Meetings

The BOJ decides the monetary policy by means of a majority vote, which is published in the Minutes of Monetary Policy Meetings. Since July 2005, the transparency has been enhanced by the publication of the number of votes for and against a policy move. In February 2007, a further step was taken and individual voting records are made public in the Minutes. This was a bold move and up to now only very few central banks are following this openness. The publication of individual voting records provides an enormous amount of personal accountability. However, the publication of individual voting records can be regarded as an issue of too much transparency (see **section 5.3.6**). The problem is that Policy Board members can be reappointed, and, by means of an individual voting record, Policy Board members' preferences can be easily understood.

Monitoring Policy Board members' preferences closely can tempt the government to reappoint members who are regarded as beneficial for the government. To date, two Policy Board members have been reappointed, namely Ueda Kazuo and Suda Miyako. Ueda started in 1998 with a two year term and the possibility of re-appointment. The rationale behind this was to avoid the term of all four members who were appointed in April 1998 ending on the same date. Regarding Suda, it is said that her reappointment was due to the problem that no adequate female successor could be found (Nakahara 2006). After ten years in office, Suda was replaced by Shirai Sayuri in 2011. However, the Bank of Japan Law does not claim that a woman has to be part of the Policy Board. Another person who had served longer than the usual five years was Nishimura Kiyohiko. Appointed in 2005 as a deliberative Policy Board member, he was promoted to Deputy Governor in 2008, and served until March 2013.

Monetary Policy Models and Forecasts

Since October 2000, the BOJ has begun to publish economic forecasts of inflation and the GDP growth rate. In the semiannually "Outlook and Risk Assessment of the Economy and Prices"[233], forecasts of each Policy Board member in regards of the inflation and the GDP are published. In April of each year, forecasts are published for the current year, whereas in October of each year forecasts of the current and following year are provided. In April 2001, forecasts of "consumer goods price inflation" (CGPI inflation) were added (Fujiwara 2005: 255-256). Then-Governor Hayami stated that the report

> "summarizes the standard scenario and risks pertaining to the economic outlook, as well as giving forecasts of prices and growth rate by Policy Board Members as a reference. The scenario and a list of possible risks given in the report have been useful in terms of both enriching discussion and improving external accountability by providing a common platform for subsequent discussions at Monetary Policy Meetings" (Hayami 2004: 541).

Since April 2005, the BOJ has decided to extend the projection period by one year, which means that the BOJ publishes forecasts for the current fiscal year and the following fiscal year in the April and October issues of the "Outlook" (Bank of Japan, 6 April 2005). Table 6-5 shows which economic models the BOJ applies to conduct such forecasts. Since 2004, the BOJ has employed the Japanese Economic Model (JEM),

[233] In 2004 the title changed to "*Outlook for Economic Activity and Prices*" (see, Note 229).

which was supplemented by the Quarterly Economic Model (Q-JEM) in 2008 and the Medium-Scale Japanese Economic Model (M-JEM) in 2009.

Table 6-5: Economic Models Applied by the BOJ

	JEM	Q-JEM	M-JEM
Since	2004	2008	2009
Literature	Fujiwara et al. (2005) Kimura et al. (2006) Ôkina et al. (2008) Miyao et al. (2008)	Ichiue et al. (2009) Fukunaga et al. (2011)	Fueki et al. (2010) Fueki et al. (2011) Saitô et al. (2011)

Source: Based on Fueki and Fukunaga (2011: 33)

Regarding the usefulness of forecast modelling, Fujiwara (2005) finds that the BOJ's inflation and growth forecasts have impact on the forecasts of academic and private agents. After the publication of forecasts in the BOJ's "Outlook", private actors adjust their forecasts which results in a decreased heterogeneity between private forecasts. Thus, forecasts by the BOJ contribute to stabilize the expectations for inflation and growth.

6.4.5 The Communication Strategy of the Bank of Japan

Due to the fact that the BOJ has no clear price stability objectives (at least until 2012), it is a logical consequence that financial markets and the general public are putting greater weight on Policy Board members public statements, e.g. regarding their standpoint on price stability. However, statements by Policy Board members are the cause of confusion in the financial markets from time to time. For instance, certain members said that the Japanese economy is not in a deflationary spiral (defure supairaru)[234], and, in 2000, some members were of the opinion that Japan's deflation was a "good deflation" (*yoi bukka geraku ron*) caused by increased competition. The communication strategy until 2001 (and much later) was dominated by the argument that in an environment of interest near zero a central bank has little power to influence prices and economic growth. The communication was limited to explaining precisely that message. Basically, statements by BOJ members indicate that the communication strategy aimed at minimizing threats to the legitimacy and independence of the BOJ, rather than fueling expectations. Owing to the "unique circumstances" of deflation and very low interest

[234] See, e.g., Minutes of Monetary Policy Meetings on 9 April 1998, or 19 May 1998.

rates in addition to the "youth" and "fragility" of the new independent BOJ (Blinder et al. 2001: 81-82), it was most important for the BOJ to defend itself by building a strategy of counteract against every critique it was confronted with.[235] A specific example of how the BOJ's lack of clear strategy in communication could damage the efficiency of monetary policy is the end of zero interest rate policy in August 2000. It can be argued that the BOJ failed to provide a quantified target range for inflation and a forecast for future inflation after deciding upon the termination of the zero interest rate policy. This could lead market participants to believe that further interest rate hikes might follow. If the BOJ had provided a better defined target and forecasts, it might have been possible to limit unwanted reactions by market participants (Blinder et al. 2001: 81-82).

6.5 The Bank of Japan and Central Bank Accountability and Transparency Indices

This section focuses on accountability and transparency indices and their application to the Bank of Japan. Quantitative measures provide additional and comparative insights into the BOJ's practice of accountability and transparency (here, in comparison with the ECB, the Fed, and the BOE). Arguably, the indexation of central bank accountability and transparency is often not investigated in as much depth as the issue of central bank independence, but has become an important subject in recent research. The previous section illustrated that the terms of central bank accountability and transparency cover several different aspects, making it a difficult task to build a comprehensive measure of central bank accountability and transparency.

The following sections will focus on central bank accountability and transparency indices. The results of the Bank of Japan will be discussed in order to gain a deeper understanding the BOJ's accountability and transparency

6.5.1 The Bank of Japan and Central Bank Accountability Indices

Measuring central bank accountability and transparency is a demanding challenge. The problems of achiving a precise classification of both concepts involve difficulties that defy simple solutions, and it is doubtful whether the construction of a transparency or

[235] See, discussion in section 8-8.

accountability index is possible without bias and arbitrariness. For example, it is not always clear to which issue of accountability or transparency "the various potential measures should be allocated. A central bank report may, by example, contribute to both transparency and accountability." (Sterne 2000: 72). As a consequence, Bini-Smaghi and Gros (2001: 7) argue that "it is tempting to assess central bank accountability and transparency by creating an indicator as done in the literature on central bank independence. We [Bini-Smaghi and Gros] have succumbed to this temptation, but only to show that indicators based on formal criteria are not useful in this field." However, this does not principally mean that research based on measuring accountability or transparency is an impossible task. It is rather the case that one must be aware of these problems if more than superficial results are to be obtained from the many cross-national measures on the issue of central bank accountability and transparency.

Regardless of the difficulties, several sets of indicators have been suggested for developing an index of central bank accountability and transparency. Indeed, a quantitative index may be useful in facilitating the comparison of central bank accountability and transparency amongst central banks. Measuring the degree of central bank accountability and transparency in quantitative numbers implicates that some subjective choices were made, for instance, which aspects to focus on or how detailed the various issues of accountability and transparency should be covered in the index. Another point is the important question of using weighted or non-weighted factors. Laurens et al. (2009: 99) state that "whether the variables impact equally on independence, or whether some of them should be given a higher (lower) weight. A widely adopted solution has been to weight all variables equally so as to reduce the potential for arbitrariness." The last decision to make is whether to use the central banks' statute or the de facto situation of central banks. The majority of scholars employ the statutes of the central banks as the main source of information. However, there is no standard procedure for a proxy of accountability and building a measure based on quantitative numbers. Indeed, some scholars mix de iure with de facto components of accountability, e.g. Laurens et al. (2009)[236], whose index will be discussed later.

[236] The final objective of monetary policy and the conflict resolution procedures are valued de iure, whereas the quantification of objectives is valued de facto. In addition, regular appearances before parliament are not clearly separated between de iure and de facto.

In addition, indices help to document changes and developments of accountability and transparency practices over time. This subsection provides a summary of the results of various central bank accountability indices, providing a comparative data set of the BOJ, ECB, US Federal Reserve and BOE. Subsequently, the accountability of the BOJ will be scrutinized in correlation with a more detailed discussion of the index by de Haan, Amtenbrink and Eijffinger (1998) and the IMF study by Laurens et al. (2009). It must be noted that this approach is not meant as a clear comparison with the other central banks, nor is it a perfectly correct assessment of the BOJ's accountability and transparency. To be more precise, it aims to provide a useful summary of the analyses carried out in previous sections.

6.5.1.1 Results of Selected Central Bank Accountability Indices

Several studies have concentrated on empirically researching measures of central bank accountability. This section introduces some major central bank accountability indices and their results for the Bank of Japan in comparisons to the European Central Bank, US Federal Reserve, and the Bank of England. Subsequently, the indices by de Haan, Amtenbrink, and Eijffinger (1998) and Laurens et al. (2009) will be discussed in more detail.

Bini-Smaghi and Gros 2001

Bini-Smaghi and Gros (2001) construct an index of central bank accountability, applying it – as done in this thesis – to four major central banks: the Bank of Japan, the European Central Bank, the US Federal Reserve, and the Bank of England. Nota bene, Bini-Smaghi and Gros (2001) do not generate a numerical index, but rather present a qualitative assessment of 15 aspects of central bank accountability. The index is divided into three subjects:

1. Ex ante accountability
2. Ex post accountability
3. Accountability procedures

Translating Bini-Smaghi and Gros' results into numerical numbers, the BOJ scores 7 points, and reaches an accountability level that is somewhat lower but still comparable to that of the the European Central Bank. In contrast, the US Federal Reserve and the Bank of England score much higher.

Siklos (2002)

Siklos (2002) constructs an index of accountability based on twelve variables, and applies it to 20 central banks, which are all from advanced industrial countries. The BOJ scores remarkably high, ranking second after the Reserve Bank of New Zealand. The focus of this index on the concept of disclosure and publications appears to be favourable for the evaluation of the BOJ's accountability.

Table 6-6 summarizes the outcome of selected accountability indices regarding the BOJ in comparison to other major central banks: the European Central Bank, the US Federal Reserve, and the Bank of England. The results of these central bank accountability indicators show that there are considerable variations in accountability. Taking the mean value, the BOJ has an accountability value of 0.61 which is higher than the ECB or the Federal Reserve. The most accountable central bank in this sample is the Bank of England which scores 0.71 on average.

Table 6-6: Results of Selected Central Bank Accountability Indices (in Normalized Values)

	BOJ	ECB	Fed	BOE
De Haan, Amtenbrink, Eijffinger (1998)	**0.46**	0.31	0.46	0.85
Bini-Smaghi, Gros (2001)	**0.47**	0.50	0.70	0.77
Siklos (2002)	**0.79**	0.71	0.56	0.69
Hughes Hallett, Libich (2006)	**0.67**	0.17	0.50	0.67
Arnone, Laurens, Segalotto (2009)	**0.68**	0.77	0.72	0.58
Mean value of central bank accountability	**0.61**	**0.49**	**0.59**	**0.71**

Source: Own calculation based on the central bank accountability indices

6.5.1.2 The de Haan et al. (1998) Central Bank Accountability Index

De Haan, Amtenbrink and Eijffinger (1998) conducted a cross-country analysis of 16 central banks by constructing an index for democratic accountability. This indicator examines the relationship between central bank independence and accountability and is distinguishes between three aspects:

1. Ultimate objectives of monetary policy
2. Transparency of actual monetary policy
3. Final responsibility for monetary policy

Concerning the first aspect, this indicator inspects whether the ultimate objectives of monetary policy are clearly defined, and if a priority exists in case of multiple goals.[237] Both the majority of economists and international organisations, such as the IMF or BIS, stress the importance of clear monetary policy objectives. For instance, the Centre for European Policy Studies (2008: 1) emphasizes the necessity of clear and precise monetary policy goals for a central bank, a prerequisite for the concept of accountability. The second aspect deals with transparency of monetary policy, or, coined differently, the communication strategy taken by the central bank. This includes the requirement to publish minutes of the Policy Board meetings and an explanation if the previously formulated targets of monetary policy have been achieved. The third aspect, final responsibility, contains three essential features, namely the relationship to the delegating authority, the presence of override clauses, and the question if the central bank key staff can be easily dismissed. Regarding the relationship to the delegating authority, usually the parliament has the ultimate responsibility for monetary policy, as it has the power to change the legal statute of the central bank and arrange the rules for the central bank. This power is referred to as ex-ante control in the academic literature. In the case of ex-post accountability, the parliament can revise the central bank law in reaction to certain behaviour of the central bank, for instance, if the targets of monetary policy have not been achieved.[238]

In a previous section about principal and agent theory, the necessity of the principal's authorization to observe the agent, i.e., the public and parliament can monitor the actions of the central bank, was emphasized. A key question is how the government manages to keep an independent central bank accountable for monetary policy. One possibility is the implementation of override mechanisms. The subject of override mechanisms[239] can be seperated into three different types, namely the right to issue instructions, the right to approve, suspend, annul or defer decisions, and the right to censor decisions on legal grounds. However, the mere existence of override

[237] It should be noted that in a legal sense it is problematic to provide the power over the primary objectives to an independent agency, which is not democratically elected.
[238] Obviously, the revision of the law is much more problematic if the parliamentary system consists of two rather than one chamber.
[239] However, the economic literature is not clear about the positive effects of override mechanisms on the degree of central bank accountability, because it is regarded as an aspect of central bank independence and not necessarily accountability (Laurens et al. 2009: 104).

mechanisms itself does not enhance the democratic accountability of central banks; rather the condition of the mechanisms must be completely apparent. Meaning, override mechanisms should be both transparent and made public. "Override mechanisms can build a bridge between the central bank and democratically elected institutions", but "it has to be ensured that the mechanism is not used as a tool for undesired political influence by the executive government".[240]

The last aspect of final responsibility focuses on the dismissal of central bank key staff through the delegating authority, which is a subject of ex-post accountability. Literature that deals with central bank independence often claims long and non-renewable terms for central bank key staff. The key question is under what circumstances central bankers can be removed. In most cases, a dismissal can be understood as a sanction for weak performance (de Haan, Amtenbrink, and Eijffinger 1998: 5-7). After having decided upon the monetary policy, monetary authorities should be held accountable. The government carefully scrutinizes the central bank's performance, making the bank accountable for its monetary policy decisions. Again, at this stage the ex-post structure of the procedure is important, because the actions are not taken simultaneously. Instead, they are subjects of different information sets. As a consequence, the policy that is the best solution in a current situation can turn out to be a mistake in the future.[241]

Table 6-7 demonstrates the results of the de Haan, Amtenbrink and Eijffinger (1998) accountability index for the BOJ, and compares it with the the European Central Bank, the US Federal Reserve, and the Bank of England. The BOJ has the exact same level of accountability as the US Federal Reserve. Similar to the results of other indices, the Bank of England has one of the most accountable central banks, while the result of the the European Central Bank demonstrates relatively low democratic accountability. Point 9 and 10 are somewhat elusive for the evaluation of the final responsibility of monetary policy in Japan.[242] Although, the government representatives attend Monetary Policy Meeting's and have the right to request a postponement of monetary policy decisions,

[240] Mihailov and Ullrich (2007) construct a model that analyses the effects of overriding of economic policy decision by the government. They find that accountability do not solve the trade-off between anchoring inflation expectations on target and output stabilization.
[241] Here again, the termination of the zero interest rate policy in August 2000 is a good example (a detailed analysis is presented in Chapter 8).
[242] For example, Sousa (2002) and Grauwe and Gros (2008) give points for the BOJ for the questions nine and ten, an evaluation the author of this thesis doubts.

the Policy Board can override the government's request, and, therefore, the government finally has no power to change monetary policy. Consequently, it is appropriate to assess the BOJ with zero points in this regard.

Table 6-7: Comparing the Accountability of Selected Central Banks – The de Haan et al. (1998) Accountability Index

Aspects of accountability	**BOJ**	ECB	Fed	BOE
Ultimate objectives of monetary policy				
1. Does the law stipulate the objectives of monetary policy?	+	+	+	+
2. Clear prioritization of objectives	-	+	-	+
3. Clear definition of objectives	-	+	-	+
4. Are the objectives quantified?	-	-	-	+
Subtotal	**1**	3	1	4
Transparency				
5. The publication of an inflation or monetary policy report	+	-	+	+
6. Are minutes published within a reasonable time?	+	-	+	+
7. Explanations of the achievement of its goals	+	+	+	+
Subtotal	**3**	1	3	3
Final responsibility				
8. Is the central bank monitored by parliament?	+	-	+	+
9. Has the govt. (or parliament) the right give instructions?	-	-	-	+
10. Is there any kind of review in the procedure to apply the override mechanism?[243]	-	-	-	+
11. Has the central bank possibility for an appeal in case of instruction?	-	-	-	-
12. Can the central bank law be changed by a simple majority in Parliament?	+	-	+	+
13. Is past performance a reason for dismissal of a Central Bank Governor?[244]	-	-	-	-
Subtotal	**2**	0	2	4
Total	**6**	4	6	11

Source: Own estimation based on the index by de Haan et al. (1998)
Note: (+) is regarded as one point, and (-) is zero points.

6.5.1.3 The Laurens et al. (2009) Central Bank Accountability Index

The IMF offers a recent and comprehensive study conducted by Laurens et al. (2009), which contains a measure of accountability for 109 countries. The detailed components of the index are presented in Appendix B. This subchapter offers an update of the

[243] For example, override mechanism are implemented in BOE, BOC, Swedish Riksbank, and RBNZ.
[244] For example, the dismissal of a Central Bank Governor is possible for RBN and conditionally possible for the BOC.

information on this index to understand the accountability of the BOJ, and focuses on difficulties of the assessment of the Bank of Japan.

Table 6-8: The Laurens et al. (2009) Central Bank Accountability Index

	BOJ*	**BOJ****	ECB	Fed	BOE
Responsibility					
1. Who sets objectives of monetary policy?	1	**1**	1	1	0
2. Is central bank subject to possible interference in monetary policy?	0	**0**	1	1	0
Objectives					
3. Clarity on final objectives of monetary policy (de iure)	0.5	**0.5**	1	0.5	0.5
4. Quantification of target (de facto)	1	**1*****	1	0	1
5. Publication of economic outlook	1	**1**	0.33	1	0.66
Ex post accountability					
6. Reporting mechanisms	0.66	**0.66**	0.33	0.66	0.66
7. Regular appearance before parliament	0	**1**	1	1	1
8. Conflict resolution procedures	0.66	**1**	0	0	1
Governance					
9. Decision-making structure	1	**1**	1	1	1
10. Clear and detailed explanation of appointment procedures	1	**1**	1	1	1
Total	6.83	**8.16**	7.66	7.16	5.83
Normalized value	0.68	**0.82**	0.77	0.72	0.58

Source: based on Laurens et al. (2009)
Notes:
* Calculation by Laurens et al. (2009).
** Own calculation
*** In February 2012, the BOJ introduced an inflation target of 1 per cent

The results of the index, presented in Table 6-8, contradict the view of the majority of accountability measures which find that one of the most accountable central bank is the Bank of England, whereas the European Central Bank is usually regarded as a central bank which is not very accountable. The author's estimation of the accountability of the BOJ is a value of 0.82, a better result than the other central banks. There are some differences in the assessment of the accountability of the Bank of Japan when comparing the work of Laurens et al. (2009) to the author of this thesis. The focus will now shift to a discussion of the most important points in which the evaluation differs from the original work by Laurens et al. (2009) (in case of consistency, a repetition of the evaluation is avoided).

Point 2 deals with interference in monetary policy decisions by another institution. The central bank scores 0 points in case of (a) the presence of government representative(s) with voting right, or (b) the need of approval of the government in monetary policy decisions. When applying Laurens et al.'s (2009) definition literally, the BOJ should score a point as neither of the requirements are given. However, the right of government representatives to request a postponement of monetary policy decisions might be interpreted as interference in the monetary policy process. Regarding Point 4, the quantification of the central bank's objective, Laurens et al. (2009), applying the data from 2003, interpreted the BOJ's quantitative easing policy period from 2001 to 2006 as a quantification of the monetary objective.[245] After the exit of the quantitative easing policy in March 2006, the BOJ returned to a conventional monetary policy framework based on the uncollateralized overnight call rate. Most recently, since February 2012, the BOJ has introduced an inflation target of 1 per cent. That is the reason why the BOJ scores a point here.

Point 7 deals with appearances before parliament. This variable combines the de iure and the de facto interaction between the central bank and the legislature. In case of the presence of a "tangible relationship" between the two, the central bank scores a point. The BOE appears on a regular basis, the ECB quarterly, and the US Fed annually (Bini-Smaghi, Gros 2001: 154), which means that all score a point. The BOJ has to appear at least twice a year, and the BOJ Governor or other key staff of the BOJ is required to appear before the Diet on request (Article 54-3, BOJ Law). As a result, the BOJ scores a point here.[246] Point 8 of the index focuses on conflict resolution procedures. Definition of conflicts means that the possibility of a disagreement between the central bank and the government must be defined. The "procedure to resolve conflict" is the course followed in the relationship between the central bank and the government in case a conflict arises. By "clear outcomes in the case to resolve conflict" the authors mean "the last resort procedures that have to be adopted in case the conflict is not resolved. This usually involves the possibility for one of the two subjects or for a third one (e.g. parliament) to have the last word at the end of the conflict resolution procedure." As a

[245] However, Eijffinger and Geraats (2006) correctly concluded that the targets for the current account balance implemented during the quantitative easing policy were not clear enough to score a point here.
[246] It must be noted that the Japanese government exercised the right excessively during the period of Governor Hayami 1998-2003.

consequence, the BOJ scores a full point. Although the Japanese government has the right to request a postponement of monetary policy decisions, the BOJ can override the government's request (Article 19, Paragraph 3).[247] [248]

6.5.2 The Bank of Japan and Central Bank Transparency Indices

This part follows the methodology of the previous part: First, this section summarizes the results of selected indices of central bank transparency for the BOJ in comparison to the European Centarl Bank, US Federal Reserve and the Bank of England. Subsequently, this subchapter discusses the evaluation of the BOJ's transparency in more detail, based on an index by Eijffinger and Geraats (2006).

6.5.2.1 Results of Selected Central Bank Transparency Indices

The issue of central bank transparency has been debated for a relatively long time, but concepts to measure it "were severely limited until central banks […] began to release more and more information." Basically, transparency is regarded as a qualitative concept. As a consequence, it is difficult to define distinct measures. However, some measures for transparency exist. One of the first studies was carried out by Bini-Smaghi and Gros (2001), who offer a simple but proficient central bank transparency index that consists of four issues of the central bank: 1. objectives 2. strategy 3. publication of data and forecasts and, 4. communication strategy. In 2000, Fry, Julius, Mahadeva, Roger, and Sterne presented a study which encompasses 94 central banks, and composes an index of policy explanations that consists of explanations of policy decisions, explanations in forecasts and predictive analysis, and, lastly, explanations in publishing assessments and research. More recent studies of central bank transparency indices includes, for example, Siklos (2002), Eijffinger and Geraats (2006), the IMF study by Laurens et al. (2009), the OECD study by Minegishi and Cournede (2009), and Dincer and Eichengreen (2010).

The construction of central bank transparency measures is an issue of subjectivity and, consequently, the results vary considerably (Table 6-9). According to the Eijffinger and Geraats (2006) index, the most transparent central banks are Reserve Bank of New

[247] Siklos (2002: 248) confirms this evaluation.
[248] The application of this process can be instructively analysed with the decision to abandon the zero interest rate policy in August 2000 (see, Chapter 8).

Zealand, the Bank of England and the Swedish Riksbank. Contrarily, the BOJ and the Swiss National Bank score worst. Estimations made by Bini-Smaghi and Gros (2001) rate the level of transparency of the European Central Bank as high, whereas others view the European Central Bank as less transparent.[249]

Siklos (2002) creates a transparency index that attempts to assess the degree of economically and institutionally relevant information published by a central bank. The disclosure performance is taken from 20 central banks, all from advanced industrial countries.[250] This index assigns the best transparency performance to the Bank of England, followed by the US Federal Reserve. The European Central Bank scores poorly, while the BOJ scores relatively well coming in at 6th place with a value of 0.74. Dincer and Eichengreen (2010), by using the transparency index by Eijffinger and Geraats (2006), have extended the sample to 100 countries and put the focus on a longer time period (between 1998 and 2005). This index reveals that Japan's transparency has risen since 2004, i.e. the BOJ scores higher than in the original Eijffinger and Geraats index.

The results of selected central bank transparency indices for the BOJ in comparison to the ECB, US Federal Reserve and the Bank of England are summarized in Table 6-9. The average value suggests that the BOJ has a higher level of transparency than the ECB (0.68 vs. 0.64). However, the result depends on which measure is taken. Together with the US Federal Reserve, all three central banks are outscored by the Bank of England, which has (as an inflation targeter) the significant highest level of transparency among the four central banks.

Table 6-9: Results of Selected Central Bank Transparency Indices (in Normalized Values)

	BOJ	ECB	Fed	BOE
Siklos (2002)	**0.74**	0.52	0.87	0.91
Eijffinger, Geraats (2006)	**0.53**	0.70	0.67	0.87
Laurens et al. (2009)	**0.79**	0.63	0.84	1.00
Minegishi, Cournede (2009)	**0.73**	0.64	0.67	0.83

[249] A survey by Reuters ranks European Central Bank last of G7 central banks.

[250] Interestingly, one principal component refers to the special recognition of the role of financial system stability. In case of an implementation of such a clause the index provides the central bank with a point. Usually, the presence of multiply objects is regarded as detrimental to accountability.

Dincer, Eichengreen (2010)	0.63	0.73	0.67	0.83
Mean value of central bank transparency	**0.68**	**0.64**	**0.74**	**0.89**

Source: Own calculation based on the central bank transparency indices

6.5.2.2 The Eijffinger and Geraats (2006) Central Bank Transparency Index

This section applies the Eijffinger and Geraats (2006) index in more detail, as this measure is a very popular and is frequently applied in the economic literature.[251] This comprehensive index for central bank transparency is based on five categories of transparency: political, economic, procedural, policy and operational transparency (see, section 6.3.6). The sample consists of nine major central banks[252] for the period between 1998 and 2002. Each of the five aspects of transparency contains three questions with equal weight and a maximum score of one. The total is the summed up value from the different transparency aspects, i.e. 15 points is the maximum score. The data was taken from published central bank and government documents available on the according websites. The detailed components of the index are presented in Appendix C. The results of the BOJ for 2002 (original assessment by Eijffinger and Geraats [2006]) and 2011 (own estimation) in comparison to the ECB, Fed and BOE are presented in Table 6-10.

Table 6-10: The Eijffinger and Geraats (2006) Central Bank Transparency Index

Aspects of central bank transparency	BOJ 2002	**BOJ 2012**	ECB 2002	Fed 2002	BOE 2002
Political transparency					
1. Formal objectives	0.5	**0.5**	1	0.5	1
2. Quantitative targets	0	**1**	1	0	1
3. Institutional arrangements	1	**1**	1	0.5	1
Economic transparency					
4. Economic data	1	**1**	1	1	1
5. Policy models	0	**1**	1	1	1
6. Central bank forecasts	0.5	**0.5**	0.5	0.5	1

[251] For instance, Lyziak et al. (2007) apply the Eijffinger and Geraats (2006) index for the central bank of Poland, Malik (2008) for Pakistan, Jarmuzek et al. (2004) for a comparative analysis of the Czech Republic, Hungary and Poland vs. the ECB. The BIS (2009) applies this index to compare monetary policy frameworks.

[252] The nine central banks are the Reserve Bank of New Zealand, the Swedish Riksbank, Bank of England, Bank of Canada, European Central Bank, US Federal Reserve, Reserve Bank of Australia, Bank of Japan, and the Swiss National Bank.

Procedural transparency					
7. Explicit strategy	0	**0**	1	0	1
8. Minutes	1	**1**	0	1	1
9. Voting records	1	**1**	0	1	1
Policy transparency					
10. Prompt announcement	1	**1**	1	1	1
11. Policy explanations	0.5	**1**	1	1	0.5
12. Policy inclination	0	**0**	0	1	0
Operational transparency					
13. Control errors	0.5	**1**	1	1	1
14. Transmission disturbances	0.5	**0.5**	0.5	0	1
15. Evaluation policy outcome	0.5	**0.5**	0.5	0.5	0.5
Total Value	**8**	**11**	**10.5**	**10**	**13**
Normalized Value	**0.53**	**0.73**	**0.70**	**0.67**	**0.87**

Source: Eijffinger and Geraats (2006). Updated data for the BOJ for the year 2012 own estimation.

Political Transparency (1-3)

As discussed in previous chapter of this thesis, the BOJ has multiple monetary policy objections without explicit prioritisation.[253] However, considerable improvements in formulating the targets of its monetary policy have been introduced by the BOJ. Since March 2006, the BOJ has released "The Bank's Thinking on Price Stability" on an annual basis which provides some guidance in regards of quantitative targets. However, the stated values are based on Policy Board members' view, and, therefore, are not the policy target of the BOJ in a strict sense (Minegishi and Cournede (2009: 38).[254] Starting in February of 2012, the BOJ introduced a new price stability goal in the medium to long term of one per cent, which offers a precise definition or quantification of its monetary policy objective. Altogether, the BOJ scores 2.5 points in regards of political transparency.

Economic Transparency (4-6)

The BOJ is close to score the maximum score in economic transparency. Regarding economic models (question 5), it is essential to know what kind of policy models the

[253] Minegishi and Cournede (2009: 37) refer to Article 2 of the BOJ Law and assess a full point to the BOJ.

[254] There exist numerous papers on the consequences of policy decisions announcements. However, all these studies concentrate on reserves targeting. Most central banks have abandon this policy tool with the notable exception of the Bank of Japan with its zero-interest-rate-policy from 1999 to 2000 (Eijffinger and Geraats 2006) and the quantitative easing policy from 2001 to 2006.

central bank employs in order to interpret its actions. Until 2004, the BOJ had not disclosed a formal macroeconomic model for policy analysis. However, since 2004, the BOJ employs the Japanese economic model (JEM) (see, e.g., Fujiwara et al. 2005), since 2008, the quarterly Japanese economic model (Q-JEM) (see, e.g., Fukunaga et al. 2011) and since 2009, the medium-scale Japanese economic model (M-JEM) (see, e.g., Fueki et al. 2010 and 2011) (see, Table 6-5).

Regarding question five in the index, which deals with forecasts of the central bank, the BOJ had improved its transparency. Since 2004, the BOJ has employed the Japanese Economic Model (JEM) (Fujiwara et al. 2005). In 2008, the BOJ introduced a new hybrid-type model named Q-JEM (Quarterly-Japanese Economic Model) (Hara et al. 2009, Fukunaga et al. (2011). One year later, the suite of models was expanded by the medium-scale Japanese economic model (M-JEM) (Fueki et al. 2010, 2011). In Eijffinger and Geraats' (2006) study, Japan does not reach the maximum score, because it explained monetary policy decisions only after changes in monetary policy until 2003. Recently, the BOJ has begun to explain policy actions also when it does not change monetary policy and, therefore, deserves a full point in the index.

Question 6 focuses on macroeconomic forecasts. The BOJ has published inflation and output forecasts semi-annually since October of 2000, starting with data for the current fiscal year in the April issue and for the current and following year in the October issue. The projection period horizon was extended in 2005 by one year in the April issue of "*Outlook for Economic Activity and Prices*". That is, the BOJ published its outlook for the current fiscal year and the following fiscal year in both the April and the October issues (Bank of Japan 6 April 2005). In 2008, shortly after Shirakawa took the helm of the BOJ, the central bank increased its transparency in terms of its views concerning growth and inflation again. The Bank started to extend the forecast horizon for growth and inflation to the current fiscal year and two fiscal years ahead.

It can be summarised that the BOJ has implemented an approach in which each individual Policy Board member estimates the suitable course of future policy interest rates by providing forecasts of the real gross domestic product (GDP), core consumer price index (CPI) and corporate goods price index (CGPI) over a two-year time horizon, "thereby taking into account market expectations on the future development of policy

rates" (Iwata 2008). In addition, since 2008, the BOJ provides information by making use of a "risk balance sheet"[255], which is published in the "*Outlook for Economic Activity and Prices*". Herein, minimum, central and maximum projections made by each voting member are summarised.

Procedural Transparency (7-9)

The Japanese central bank scores 2 points concerning procedural transparency. The BOJ publishes detailed minutes in a timely fashion[256], including individual voting records[257] (individual accountability), and the comments made by the two government representatives. Already since 2000, the BOJ has started to publish detailed minutes, thus, assuming the role of a forerunner for other central banks (e.g. US Federal Reserve from 2005). Since 2007, the BOJ has improved its procedural transparency further, releasing the voting record immediately after Monetary Policy Meetings. [258]

Policy Transparency (10-12)

Regarding question 11, the BOJ has been systematically providing policy explanations since 2003. Previously there were some occasions when no explanation was provided for decisions to keep policy unchanged. Question 12 focuses on explicit future policy inclination.[259] From 2008 on, the BOJ had followed the trend set by the Fed to provide "verbal forward-looking guidance in policy decision statements" (Minegishi and Cournede 2009). However, this arrangement is not sufficient policy inclination to score a point. Altogether, the BOJ scores two points in the area of policy transparency.

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[255] On 30 April 2008, Policy Board members discussed in the Monetary Policy Meeting how the Risk Balance Charts should be used. "A few members expressed the view that, in a situation of high uncertainty, the Risk Balance Charts, each of which showed a probability distribution of risks aggregated from those produced by individual Policy Board members, would act as a valuable communication tool, enhancing monetary policy transparency. One member said that the information that was most important to convey was about the mechanism behind economic and price developments, and it was necessary in the Bank's communication to explain in a well-balanced manner both the mechanism and the figures indicated by the Risk Balance Charts, to prevent the figures from taking on a life of their own. A few members said that the Bank should decide whether it would continue to release the Risk Balance Charts after carefully assessing the market's reaction." (BOJ 2008, Minutes of 30 April 2008).

[256] Usually, the BOJ releases the minutes shortly after the subsequent meeting.

[257] Geraats (2005: 20) remarks that the disclosure of voting patterns is remarkably uncommon. Besides the BOJ only a few central banks, such as Bank of Korea, Bank of England and the Federal Reserve, Swedish Riksbank and the Polish National Bank are publishing voting records.

[258] Before that the record had been disclosed only at the time of the publication of the minutes.

[259] The Reserve Bank of New Zealand was the first central bank which released its own policy rate projection. Norway and Sweden followed this practice in 2005 and 2007 respectively (Minegishi and Cournede 2009).

Operational Transparency (13-15)

The BOJ scores two points in operational transparency. The score of 0.5 in Eijffinger and Geraats index regarding question 13 - control errors - refers to the fact that the operating target of the outstanding balance of the current accounts at the BOJ during the quantitative easing policy between 2001 and 2006 was rather vaguely specified and had considerable fluctuations without sufficient explanations. After the termination of the quantitative easing policy, the BOJ's main operation target is the uncollateralized overnight call rate. Thus, the BOJ scores a full point. Although the BOJ provides information on macroeconomic disturbances on basis of a monthly analysis of the current macroeconomic situation (in the *Monthly Report of Recent Economic and Financial Developments*), it has not (yet) discussed past forecast errors. Therefore, the BOJ obtains only 0.5 points. Although the Japanese central bank does provide an informal evaluation of policy outcome in the *Monthly Report of Recent Economic and Financial Developments*, an explicit account for deviations between the policy outcomes and the objectives is not sufficiently provided.

6.5.2.3 The Development of Bank of Japan's Transparency

Many studies have demonstrated that in recent years central banks have adopted more transparent communication strategies, and have converged strongly among OECD countries (see, Minegishi and Cournede 2009, Dincer and Eichengreen 2010).[260] This argument holds true for the Bank of Japan. In the original work of Eijffinger and Geraats (2006), the BOJ scored only 8 points, which was second lowest after the Swiss National Bank. The Bank of Japan (2002, Self assessment) has claimed that it continuously makes the effort to enhance its transparency in regards of its monetary policy. Table 6-10 and 6-11 confirms this view, and demonstrates that the BOJ's transparency has increased to a considerable degree.

Eijffinger and Geraats (2006) indicator compares transparency between 1998 and 2002, and shows that the level of transparency has improved in most central banks over time. However, the BOJ's transparency between 1998 and 2002 has not improved, which is a very untypical result in international comparison (the other notable exception was the Bank of Canada). However, Dincer and Eichengreen (2010: 35) argue that since 2003

[260] However, one aspect which still varies a lot across central banks is the transparency about the decision-making process with respect to minutes and voting records.

the BOJ's transparency has essentially raised. Various other central bank transparency indices confirm this view and suggest that the BOJ had made big progress in central bank transparency. In an OECD study, Minegishi and Cournede (2009) showed that the Bank of Japan had made the largest improvement towards central bank transparency among all samples, increasing its score from 0.36 points in 1999 to 0.73 points in 2009, which is a plus of 0.37 (Table 6-11).

Table 6-11: The Development of the Bank of Japan's Transparency

	Dincer and Eichengreen (2010)	Minegishi and Cournede (2009)
1998	0.53	NA
1999	0.53	0.36
2000	0.57	0.52
2001	0.53	0.57
2002	0.53	0.57
2003	0.53	0.61
2004	0.63	0.61
2005	0.63	0.62
2006	0.63	0.64
2007	NA	0.68
2008	NA	0.73
2009	NA	0.73
Difference 1999-2006	+0.10	+0.28
Difference 1999-2009	___	+0.37

Source: Own calculation based on Dincer and Eichengreen (2010) and Minegishi and Cournede (2009)

6.6 Conclusion

After defining and explaining the terms of central bank accountability and transparency, this chapter analysed the Bank of Japan's accountability and transparency. Based on the new BOJ Law, the BOJ has increased its accountability and particularly its transparency to a substantial amount. This section has demonstrated that the assessment of the BOJ's transparency and accountability in different indices of central bank accountability and central bank transparency depends on the structure of the index. Generally speaking, the BOJ scores well if the index focuses mainly on publications of minutes' of Monetary Policy Board Meetings and the voting structure, or the disclosure of information. In

contrast, if the index shows a priority on objectives of monetary policy, the BOJ scores comparatively poor. This has changed since February 2012, when the BOJ introduced an inflation target. A second conclusion of this chapter is that the accountability and transparency of the Bank of Japan has increased over time to a high extent since the revision of the Bank of Japan Law in 1998. This observation is confirmed by an update of the accountability index by Laurens et al. (2009) and the transparency index by Eijffinger and Geraats (2006). This section demonstrated that the accountability and transparency of the BOJ is higher than in the evaluations of the original works.

7. THE DE FACTO INDEPENDENCE OF THE "OLD" BANK OF JAPAN

7.1 Introduction

The requirement for independent central banks is deep-rooted in both economic theory and in political practice, and, at present, many governments have granted their central banks' independence. However, de iure central bank independence does not guarantee de facto independence (Cukierman 2005; Itô 2009: 62). For instance, Capie et al. (1994: 50) argue that it is impossible to understand the degree of central bank independence from the perspective of legislation alone. This chapter analyses the independence of the "old" Bank of Japan in a de facto sense, basing the following chapter on selected case studies.

Cross-country analyses about central banks usually analyse the de iure environment, and conclude that the Bank of Japan has been independent from political influence since the BJL revision (see, for instance, Gerdesmeier, Mongelli and Roffia 2007: 14). However, looking behind the central bank statute and analysing the central bank's actual independence is worthy of attention. Cukierman (2005: 40) notes the following:

> "Due to its multi-dimensional nature there is no single compelling measure of central bank independence. Much of the academic literature of the last twenty years has utilized legal characteristics from central bank charters to construct aggregate indices of legal independence. However, since charters normally are highly incomplete contracts, actual independence is also affected by numerous more or less formal arrangements between governments and the central bank. As a consequence, there normally are discrepancies between the legal and the actual independence of a central bank."

As a result, the de facto independence of a central bank may differ to a high extent from its de iure independence (Cukierman 1992; Klomp and de Haan 2010; Wagner 1999: 8-9). De facto independence includes informal measures of central bank behaviour. Boylan (2001: 66) argues that:

> "Informal measures attempt to gauge less visible aspects of central bank behavior. Unofficial arrangements between the central bank and various parts of the government, the quality of the bank's research department, and the personalities of key individuals in the central bank are all variables thought to affect behavioural autonomy."

Following a similar line of argument, Louis Rasminsky, former Governor of Bank of Canada, stated in 1966 that "The formal status of the central bank varies a great deal

from country to country. In any case this is a field in which the real situation is not likely to be revealed by the terms of the statute. Much depends on history and tradition and a fair amount even on the personalities involved."[261] Stressing the importance of analysing central bank independence not only via the central bank statute, but rather via the overall institutional setting of a central bank, the Italian central banker Carlo Ciampi (Financial Times 1992, quoted from James 2010: 14) stated that "a meaningful appraisal of central bank independence requires a thorough evaluation of the institutional setting and of the bank's modus operandi as developed over time and consolidated in practice." The determination of central bank independence involves "a fairly intimate knowledge of the structure, organisation, and the working practices of the institution, to say nothing of the personalities in both the central bank and the government" (Capie et al. 1994: 55).

This section provides an overview of the relationship between the Japanese Government with the Bank of Japan and the decision-making process of monetary policy before turning to the new Bank of Japan in the subsequent chapter. This procedure enables a comparative view of the BOJ to be established.

7.2 The System of Alternating Bank of Japan Governors

Since the end of 1960s, the governorship of the BOJ has been characterized by a well-established pattern in which the position of the BOJ Governor was alternately filled by a former MOF top bureaucrat and a Bank official. Table 7-1 illustrates that the Deputy Governor was assigned by the other organisation respectively. The promoted MOF official would be a former Administrative Vice Minister[262] (van Rixtel 2002: 129; Iwata 2009: 18-21; Kawakita 1995: 67-70; Motoyoshi 2006; 30-31; Yamawaki 2002: 248-249). According to Uekusa (2008), a very attractive job for retiring MOF officials was to become the Governor of the BOJ as a form of *amakudari* ("descent from heaven"). In other words, as noted by Grimes (2001: 197), the post of the BOJ Governor was the "biggest prize among MOF bureaucrats' post-retirement jobs." The agreement of rotating Governors guaranteed the Ministry a high degree of control over the Bank's activities.

[261] This quote is taken from Siklos (2002: 2)

[262] Amyx (2000: 19) commented that "[t]he staffing of the top BOJ post by a former MOF AVM [Administrative Vice Minister] was problematic – not only in terms of MOF influence on BOJ policy but also in terms of political influence on the central bank. This was because every MOF AVM was well versed in annual budget negotiations with politicians and was necessarily very political."

Table 7-1: The System of Alternating BOJ Governors from 1969-1998

Period	Governor	Affiliation	Deputy Governor	Affiliation
1969-1974	Sasaki Tadashi	BOJ	Kôno Tsûichi	MOF
1974-1979	Morinaga Teiichirô	MOF	Maekawa Haruo	BOJ
1979-1984	Maekawa Haruo	BOJ	Sumita Satoshi	MOF
1984-1989	Sumita Satoshi	MOF	Mieno Yasushi	BOJ
1989-1994	Mieno Yasushi	BOJ	Yoshimoto Hiroshi	MOF
1994-1998	Matsushita Yasuo	MOF	Fukui Toshihiko	BOJ

Source: Own compilation based on Bank of Japan webpage

All efforts to overcome this tacit agreement of rotating governorship failed. In 1994, Takemura Masayoshi from the New Party Sakigake, who as the Finance Minister had the right to recommend the next BOJ Governor, tried to abandon the sticky pattern of rotating BOJ Governors. Takemura intended to nominate a candidate from the private sector. The name of economist Tanaka Naoki as a prospective following BOJ Governor circulated in the press. In contrast, the MOF lobbied for Matsushita Yasuo, a retired MOF top bureaucrat. However, Takemura's effort to overcome the system failed since the ties between the BOJ and the Ministry were too strong and could not be broken.[263] The Finance Minister acquiescently commented that "neither the bureaucracies nor the markets were prepared for a Governor who broke the pattern". In order to preserve the stability of the financial system, Takemura finally appointed the candidate from the MOF, Matsushita Yasuo, as BOJ Governor (Grimes 2001: 197-198; Yamawaki 2002: 247-249).

Owing to this alternating system of BOJ Governors, it is obvious to assume that MOF-affiliated Governors followed the views and "recommendations" of the government to a higher degree than BOJ-affiliated Governors. In contrast to this assumption, Kamikawa (2006: 132) argues that this system was favourable to the BOJ, because it guaranteed that a BOJ-affiliated person would become Governor every second time, and excluded other candidates from the process. Kamikawa states that:

> "In 1964, there was a conflict over the Governor post between the Ministry and the Bank. Prime Minister Eisaku Sato took the occasion to

[263] It must be noted that powerful forces in the BOJ backed Matsushita. Takemura asked Mieno whether to nominate BOJ-career Fukui or, as an alternative to re-appoint Mieno for a second term as BOJ chief. Both possibilities were denied by the BOJ Governor who recommended Matsushita (Grimes 2001: 198; Yamawaki 2002: 247-248).

> appoint a private bank president as the Governor [Usami Makoto]. The tradition that the Bank and the Ministry got the position by turns seems to be based on reflection on this. The Bank became able to get the position certainly once in twice."

It can be assumed that MOF-affiliated Governors have a bad performance regarding their inflation-records. However, Cargill, Hutchison and Itô (1997: 187-188) do not find significant evidence of such a correlation.[264] Similarly, in a recent study, Harada (2008) evaluates all BOJ Governors Sasaki Tadashi to Fukui Toshihiko and finds no evidence that a Governor of BOJ origin performs better than a MOF-rooted Governor. In comparison with the predecessor, the real gross domestic product growth must be higher and the inflation rate more stable in order to obtain a positive evaluation. According to this approach, Morinaga (MOF), Maekawa and Fukui (both BOJ) performed relatively well. On the other hand, among the Governors with a weak performance, three came from the BOJ (Sasaki, Mieno, and Hayami) and only two from the MOF (Sumita and Matsushita). As a result, origin alone does not make a good central bank leader.

7.3 Temporary Assignments (*shukkô*)

One custom of *amakudari* (descent from heaven) was the practice of *shukkô* (temporary transfer of employees). It was common practice to assign staff members between the MOF and the BOJ on a temporary basis. One MOF official was always in the Credit and Market Management Department of the BOJ. Another retired MOF official filled one of the six positions as BOJ Executive Director, and an additional bureaucrat was assigned as Executive Auditor. In the case of the BOJ, "temporary assignment to the MOF seemed to have been an important prerequisite for becoming a senior executive in the BOJ's important Policy Planning Department".[265] BOJ officials were sent both to the Finance Ministry and to other government institutions, such as the Research Department of the Economic Planning Agency, the Ministry of Foreign Affairs, the Export-Import Bank of Japan, and, in addition, to some private banks (van Rixtel 2002: 127-129; 174). In short, it can be argued that the practice of *shukkô* increased the control of the Ministry over the Bank of Japan. However, the following section presents some facts

[264] Theoretically, it is possible that a MOF-affiliated Governor can be an example of a "Thomas Becket behaviour" what former Governors of the German Bundesbank, such as Hans Tietmeyer, strikingly demonstrated. In the Japanese case, however, given the strong ties of bureaucrats with their Ministry, such behaviour is most unlikely.

[265] Miller (1996: 25) finds that working in the Policy Planning Department was a springboard for promotion to the Executive Board and subsequently to the Policy Board.

that the "close" relationship between the BOJ and the Ministry was not entirely disadvantageous for the Bank.

7.4 The Ministry of Finance as Safeguard of the Bank of Japan

As already demonstrated in a former section of this thesis, the BOJ was legally dependent on the Government, in particular on the MOF.[266] It can be said that the BOJ was nothing more than an extension of the Ministry. Regarding the relationship to the MOF, several sources characterized the BOJ in a derogatory manner, such as "manservant of the MOF" (Mikitani and Kuwayama 1998: 16), as the "Nihonbashi honkakuchô branch office of the Ministry" (Kawakita 1995: 64), the "Ministry of Finances' Bank of Japan Section"[267] (Asahi, 20 June 1996), or "office within the MOF's Banking Bureau" (Henning 1994: 75).[268] Kyûno, Masao (1996), Professor at the *Seinangakuin* University even titles the BOJ as the "maid of the government" (*seifu no jijo*). Another term is "subcontractor of the MOF" (*ôkurashô no shitauke*) (Yomiuri, 21 March 1998). These terms imply the plausible assumption that the BOJ was a "mere follower of the Ministry" (Nakakita 2001: 56). A former section of this thesis has demonstrated that this subordination of the BOJ is based on the central bank's legal framework.

However, it can be argued that this subservient relationship had some advantages for the BOJ. Several scholars highlighted the MOF's role in protecting the BOJ from political influence, and refer to a beneficial "comparative autonomy of the Ministry-Bank coalition" as a successful model for price stability, which gained an excellent reputation worldwide (e.g., Cargill, Hutchison and Itô 1997: 192; Asahi, 20 June 1996). In other words, it can be argued that the BOJ was hiding behind the MOF's protection against political circles (Fujiwara, Interview, Business Week, 12 June 2000). Two important features characterized the Ministry: first, the MOF was considered as more conservative regarding monetary issues than the government, and, second, the Ministry enjoyed "an unusually high degree of autonomy from politicians". On the basis of these two conditions, the MOF acted as a benevolent protector of the Bank, and absorbed political

[266] For a more detailed analysis of the relationship between the BOJ and the MOF before the law revision, see Kawakita 1995, chapter 2 or Kanegae 1995).
[267] *Ôkurashô nihonbashi honkakuchô shucchô sho* and *Ôkurashô nichigin ka*. The term nihonbashi honkakuchô refers to the location of the Bank of Japan.
[268] Mikuni and Murphy (2003: 49) find that Ikeda Hayato, Japan's Prime Minister in the 1960s, had considered that the BOJ's function is to serve as the MOF's agent.

pressure acting like a “buffer” between the BOJ and political pressure (Henning 1994: 75-77; Cargill, Hutchison and Itô 2000: 89-91). In practice, if the BOJ and the MOF followed the same policy direction, their combined power was usually strong enough to resist political pressure. On the contrary, in case of disagreement between the two organizations, political players were most likely to gain the upper hand. Discrepancies about monetary policy happened frequently as the MOF had “a broader set of objectives” than the BOJ. That is, not only price stability, but rather wide-ranging subjects, for instance, exchange rate stability, high economic growth rate, high employment rate and budget deficit consolidation were issues of concern for the MOF (Henning 1994: 75-76).

In many situations the MOF’s role as a benevolent protector against politicians was useful for the Bank. On the other hand, having the MOF as safeguard was connected with a high cost for the BOJ. First, the MOF’s broader objectives were the basis for the incentive to exert pressure on the BOJ, and to use monetary policy tools to achieve their own goals. Hence, an independent MOF was not a perfect substitute for an independent central bank and price stability. Second and more important, the strong MOF-BOJ relationship supported the development of a rotating Governor system between the two institutions, resulting in the fact that every second BOJ Governor was chosen by the Ministry (Table 7-1), a rather unfavourable condition for the independence of a central bank (Cargill, Hutchison and Itô 1997: 188). According to Henning (1994: 76-77), the MOF and BOJ conducted a monthly meeting in which the MOF’s Administrative Vice Minister of Finance and the BOJ’s Deputy Governor, together with their senior subordinates, gathered to discuss monetary issues. Another important issue of discussions were the meetings of the MOF’s Director General of the Banking Bureau and the BOJ’s Director of the Department of Policy Planning, who discussed the appropriate level of the discount rate. In case of conflicts, higher-ranking officials were consulted. Serious problems of this practice were “leaks”, namely the “unauthorized disclosure of policy deliberations”, what sometimes disturbed the bargaining process. That is, in case of discrepancies between both organizations, deliberately disclosing information to the public was a strategy by the BOJ. This strategy was choosen in order to gain advantage in “behind-the-scenes-bargaining” over the MOF. It can be argued that this practice was a compensation for the BOJ for its “institutional subordination” to the MOF.

Lohmann (1998) argues that it is irrelevant whether or not a central bank is de iure independent, but rather the way the central bank is embedded in a larger political system. Thus, even if the Bank of Japan is formally subordinate to the Ministry of Finance, monetary policy will be insulated from the pressures of electoral and partisan politics to the extent that the Ministry of Finance is independent" (Lohmann 1997: 65). Lohmann (1997: 77) points out that in the "old" Japanese system, the Japanese government with its powerful bureaucracy and single-party rule can commit to price stability without a monetary institution, i.e., institutions are irrelevant. Mabuchi (1997: 167) finds it intriguing that before elections monetary policy decisions mabe by the BOJ were extraordinarily rare. This might be a result of enormous pressure by LDP lawmakers. Mabuchi (1995) argues that the BOJ's dependent status to the government explains to a large extent the reason for continued low-interest policies, a positive factor that supported the rapid growth economy. This, in turn, leads to the conclusion that a dependent central bank might be a beneficial institutional set up. On basis of the described relationship between the BOJ and MOF (as a part of the government), the following section explains the decision-making-process of monetary policy.

7.5 The Monetary Policy Decision-Making Process

Legally, the BOJ was not permitted to devise and implement monetary controls on its own. Thus, one set of scholars, for instance Suzuki (1996: 22) and Kawakita (1995: 63-64), argue that the decision concerning important issues of monetary policy, such as the discount rate, was in reality controlled by the MOF (Figure 7-1). Horiuchi (1993: 103) states that "the BOJ was subordinate to other government agencies in the policy-making process. It was requires by law to have its monetary controls conform to the pattern of capital fund allocation as coordinated mainly by MOF and MITI." However, the BOJ attempted to fight for more control over monetary policy in order to maintain at least some semblance of power. Under the old law, an interest rate hike by the BOJ was regarded as a victory, and a rate cut as a defeat for the central bank (*kinri wo agereba kachi, sagereba make*). That is, the performance of Bank of Japan Governors' was evaluated according to his record with X wins and Y losses in which X stand for rate hikes and Y for rate cuts. As a result, it was a very complicated task for the BOJ to raise rates, but it was important to demonstrate that the BOJ was able to act independently from time to time. It was especially difficult for the BOJ when it came to finding the

right timing for rate hikes, since a failure was utilized by the Ministry to gain more control (Kawakita 1995: 60; Motoyoshi 2006: 50-53).

The strong ties between both the BOJ and the government with the MOF required a special process of decision-making for monetary policy. For example, if the Bank intended to raise interest rates, it had to follow complex rules of intense consultations with the Ministry, the Finance Minister and the Prime Minister in advance. Without consensus of the most important key players, policy changes were most unlikely. A multifaceted procedure of comprehensive consultations with tacit agreements had become common practice for Japanese monetary policy making (Henning 1994: 70-72). Coined differently, the decision-making process was and is characterized by a special consensus-building process (*nemawashi*). Miller (1996) describes this Japanese-style decision-making process for monetary policy as a so-called preclearance system.[269] Nemawashi is an informal negotiation process, seeking approval from all parties concerned before officially suggesting a proposal. Consultations between all parties concerned have often a behind-the-door character, and usually require a large amount of time. This system of pre-consultation is based on two conditions: first, a stable political environment with long-term relationships between the actors (Government-MOF-BOJ), and, second, a focus on rapid economic growth. Without one of these conditions, this decision-making system of preclearance would not have been functioned.

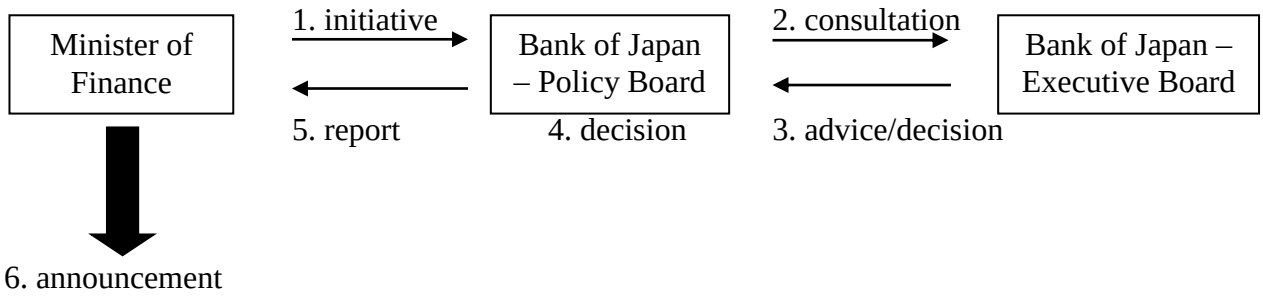
If the BOJ planned a policy move, for instance an interest rate hike, BOJ officials had to consult and convince their counterparts in the Ministry, and needed the "explicit private approval by the MOF" (Henning 1994). Most importantly, the top levels of the MOF bureaucracy had to be supportive of this certain policy move. Subsequently, the bureaucrats consulted the Finance Minister.[270] If the Minister agreed, he tried to persuade other Cabinet Ministers. Once the majority backed the move, the rate hike was decided upon. However, obviously the most powerful person in this process was the

[269] Miller (1996: 20, note 82) notes that the term 'preclearance' to describe the Japanese form of bureaucracy was first suggested by Professor Kanda Hideki, University of Tôkyô, Law Department.
[270] According to Henning (1994: 72), "in practice the [finance] minister acts more often as a conduit for political pressures." However, due to influence from his new institution the finance minister "is likely to express monetary preferences more conservative than those of other members of the Cabinet, influenced as he is by MOF, and indeed more conservative than his own before he became minister."

Prime Minister, and his veto could stop every effort for a policy change (Cargill, Hutchison and Itô 1997: 182-183). [271]

Figure 7-1 illustrates the decision-making process and timing of monetary policy. Regarding the first step, the initiative for a monetary policy change, could be initiated by either the MOF or the BOJ, depending on the key figures and economic and political circumstances. In case the MOF was the initiator, a consultation between the BOJ's Policy Board and the Executive Board took place after the MOF's demand. Formally, the decision was made by the Policy Board, but in practice the process was dominated by the Executive Board giving "advice" to the Policy Board. Finally, after a report to the Minister of Finance the decision was announced. Figure 7-1 demonstrates the fact, that a policy change by the BOJ alone was difficult, but rather a consultation/debate with the MOF took place.

Figure 7-1: The Monetary Policy Decision-Making Process before the Law Revision



Source: Own compilation based on Goerdeler (1987: 62)

To sum up, the BOJ usually sought agreement with the Ministry on major monetary policy decisions, both for changes in the reserve requirements as to what was a formal obligation of the Bank of Japan Law, but also for changes in the key interest rate, the discount rate. However, the following chapter demonstrates that the Bank, despite its legal constraints, achieved a remarkable degree of a de facto independence.

[271] Henning (1994: 71) distinguishes between different Prime Ministers and argues that, for instance, Ikeda and Tanaka "dominated monetary policy setting", whereas Satô, Takeshita, and Kaifu left main monetary policy decisions in the hands of the Bank. Prime Minister Nakasone granted relatively much freedom to Governor Maekawa but gave strong rules to Sumita.

7.6 The Bank of Japan's De Facto Independence

> "The BoJ's degree of de facto independence seems to have varied considerably over the past few decades, even at times when its legal framework was constant." (Lukauskas and Shimabukuro 2006: 130)

This quote confirms the findings from a previous section, namely that de iure central bank independence is not necessarily on the same level as the de facto independence. Chapter 5 has examined the formal status of the Bank of Japan Law of 1942, and concluded that the Bank of Japan was a dependent central bank. This chapter briefly examines the de facto conditions of the BOJ. In spite of the BOJ's very limited legal independence, certain scholars argue the Bank indeed gained a relatively high level of de facto independence (Blanchard 2000: 204; Capie et al. 1994: 169; Horiuchi 1993: 114; Kamikawa 2006; Mabuchi 1995).

For example, if the MOF would push its legal limits, and enforce its preferred monetary policy direction, or punish the Bank for inobservance, i.e., by means of a dismissal of the BOJ Governor, the political costs would be immense and probably exceed the expected benefits. As a consequence, the Ministry refrained from exercising the most drastic control mechanism, and it never issued a direct directive to the BOJ or exercised its power to dismiss a Governor or Deputy Governor, because the Ministry feared strong criticism from the media and the public. A removal of the central bank's Governor would be particularly delicate, if it was politically motivated, and if the MOF just desired to interfere in the Bank's monetary policy. Miller (1996: 9-11) finds that despite its high-level legal endowments, the absence of open confrontation between the two agencies demonstrates that the de facto control of the Ministry was limited. Goerdeler (1987: 50) argues that, although the BOJ gained a certain extent of de facto independence, it was still dependent on the government. As a matter of fact, although the government, in particular the Finance Minister, had a high degree of authority over the Bank, the relationship between the Bank and the Ministry was generally characterized by cooperation. However, many exceptions demonstrate that the relationship was not permanently harmonious. In many occasions, fierce battles between the BOJ and MOF over monetary policy took place.

Miller (1996) applies case studies in which conflicts between the Bank and the Ministry occurred, and concludes that the de facto independence of the BOJ was much higher

than the written statute of the Bank of Japan would suggest. In many cases the Bank successfully resisted pressure, "despite the MOF ostensibly overwhelming legal authority." As a consequence, the (Western) concept of central bank independence is insufficient to explain the case of the Bank of Japan. From time to time, the Bank managed to act independently, while other times it is little more than subservient to the MOF:

> "In the Bank of Japan, we do not observe either an independent or a dependent central bank; rather, we observe an institution engaged in a form of preclearance with other interested parties-most importantly the MOF-during the implementation of governmental policies" (Miller 1996: 9).

However, since the 1970s, the BOJ has been able to strengthen its position towards the Japanese Government and the MOF.[272] It is ironic that an increased de facto independence was (partially) facilitated by a major policy mistake of the Government. During the oil-shock in 1972, the government pressured the BOJ not to raise the interest rate. The government's request turned out to be a vast error, ending in sky-scraping inflation rates. From that time on, the Bank could always claim that its judgement of the Japanese economy was correct, and found itself in a better position when it came to disagreements with the Ministry about monetary policy. Additionally, after an excellent inflation record in the period from 1975 to 1985, the BOJ gained a reputation[273] of a successful 'inflation fighter', which made political interference even harder, and, according to Cargill, Hutchison and Itô (2000: 90), a "de facto independence seemed to have been established".[274] Another significant factor for the BOJ's de facto independence was that open market operations gained more importance as a monetary policy tool during the time of deregulation of the financial markets. The BOJ enjoyed full discretion over open market operation. Therefore, Kamikawa (2006) argues that the BOJ acted quite independent from the Prime Minister and MOF during the loosening of monetary policy in the late 1980s. However, Henning (1994: 70-71, note 22) reports that then-Finance Minister Hashimoto declared in 1990 that the BOJ had complete

[272] Mabuchi (1995) argues that the BOJ gained a de facto independence from the MOF already during the occupation era.
[273] For instance, Friedman (1985) hails the BOJ for its successful practice of monetary aggregate targeting in the 1970s and 1980s; a policy tool that was introduced by BOJ Governor Morinaga (For more information, see Suzuki (1986)).
[274] Grimes (2003: 74) argues that although the BOJ's independence increased during the tenure of Morinaga (1974–79) and Maekawa (1979–84), "significant external control mechanisms over the bank remained in place. These mechanisms came into play when policy disagreements arose between the central bankers and the central government."

control over the discount rate, building the image that the BOJ acts independently. This drives the conclusion that the BOJ was used as the scapegoat for high interest rates.

Another aspect is that the use of CPI inflation rates is insufficient to evaluate the BOJ's independency, at least since the latter half of the 1980s. In comparison to stable CPI rates, stock prices and land prices increased radically, resulting in an asset price bubble in the late 1980s. The majority of scholars suggest that the BOJ's easy monetary policy was one factor behind this unfavourable development (Fukuda 2001: 140). However, Okina, Shirakawa and Shiratsuka (2001) find that in the latter half of the 1980s the BOJ was strongly influenced by political pressure to conduct easy monetary policy. The BOJ was pressured to prevent the appreciation of the Yen, and to reduce the current account surplus. As a consequence, CPI inflation rates for the period between 1985 and 1990 are insufficient to judge whether or not the BOJ has in fact achieved de facto independence.

7.7 Conclusion

The political and economic system in Japan is characterized by peculiar features. One is the complex relationship between the Japanese Government, Ministry of Finance and Bank of Japan. This complex relationship is the reason why it is difficult to attempt to understand the case of the BOJ using a simple, dependent-independent central bank Anglo-Saxon framework. Moreover, it is the reason why the application of central bank independence indexes from the previous chapter must be emploxed carefully. This chapter concludes that a simple distinction between dependent and independent central banks is an insufficient approach to understanding central banking in Japan. For example, it was shown that, although the legal independence of the old Bank of Japan was very limited, the BOJ has managed to gain a considerable amount of de facto independence since the 1970s.

8. THE DE FACTO INDEPENDENCE OF THE "NEW" BANK OF JAPAN

The previous chapter offered a first analysis of the de facto environment of the Bank of Japan's independence under the old BJL of 1942, serving as preparation for the following case studies on the Bank of Japan under the new BJL of 1998. This chapter places special focus upon the relationship between the Bank of Japan, the government and politicians. The chapter will aim to show how the government tried to exert influence on monetary policy decisions made by the Bank.

8.1 Introduction

The Bank of Japan Law revision in 1998 granted the Bank independence. However, the BOJ does not sit in an ivory tower, but rather it is accountable for its decisions to the public, the Japanese Government and the Diet. The revision of the BJL changed the legal relationship between the BOJ and the Japanese Government essentially (see, Chapter 5). This section focuses on the changed relationship between the central bank and the government on a de facto basis and how political influence and pressure was conducted.

Basically, there are two sets of political influence exerted on a central bank by the government and politicians. The first is by means of the appointment process of the central bank's key staff. The second one is via interference in the monetary policy decision-making process. According to Chappell et al. (1993), the first is an "indirect" channel of political influence, whereas the influence on the process of monetary policy decision-making can be regarded as a "direct" channel of political influence. There are several explanations for political pressure on the central bank or conflicts between the government (and politicians) and the central bank, for instance, if the government disagrees with the current stance of monetary policy. Another plausible reason is if the central bank's outlook for future economic growth differs from that of the government (Siklos and Bohl 2005).

This chapter presents a detailed case study of the Bank of Japan in relation to the above-mentioned two subjects of governmental influence. The first regards the appointment process of three Governors of the newly independent central bank: Hayami Masaru, Fukui Toshihiko and Shirakawa Masaaki. In addition, the appointments of Deputy Governors, deliberative Policy Board members and BOJ executives are briefly covered

in this chapter. The second major channel of government interference concerns, as stated before, the process of monetary policy. This section will attempt to provide insights into some key decisions in monetary policy from 1998 to 2006. First, the decision to introduce the zero interest rate policy (zero interest rate policy) in February 1999 will be of interest. Second, the decision to end zero interest rate policy and the raise the interest rate in August 2000 will be examined. The third issue concerns the introduction of the quantitative easing policy in March 2001 with the decision to end quantitative easing policy in March 2006 and the raising of the interest rate in June 2006 and February 2007. These issues will be investigated in relation to the political economy of an independent central bank. Before an analysis of political interference is presented, a history of recent monetary policy events is provided to enable a deeper understanding of the subsequent analysis of political pressure on monetary policy decisions.

8.2 The Relationship between Central Banks and Governments

Since the subject of central bank independence became popular, economic literature has concentrated on the relationship between governments and central banks (Bade and Parkin 1988). Although more and more governments granted central banks independence, politicians in many countries sought to continue to exert influence on monetary policy decisions. The relationship between central banks and governments is particularly difficult and is characterized by many cultural specifications.

Havrilesky (1995) analyses the political pressures exerted by three principals on the allegedly independent US Federal Reserve: the Treasury (executive), the Congress (legislative) and the private financial sector. In another study, Havrilesky (1994) uses newspapers as a primary source (*Wall Street Journal*) and identifies the number of articles which contain pressure imposed by the Treasury on the central bank as an indicator. Calls and pressures for changes in the Federal Funds Rate (FFR) signal the Treasury's preference of monetary policy.[275] In a next step, Havrilesky measures the Fed's responses to these signals through the movements of the FFR.[276] The political

[275] Policy signals by the principal can influence monetary policy. In combination with credible threats of punishment in case of the agent's misconduct the affect is even higher (Bernhard 2002: 58).
[276] In an analysis of the German Bundesbank, Maier (2002) extends the method by Havrilesky in two aspects. First, he adds signalling from interest groups such as the financial sector, employers, trade unions plus other influences such as academic researchers, international institutions. Second, Maier introduces an

economy literature suggests that electoral and/or partisan factors are significant sources of conflict, in particular, if the central bank installs a monetary policy that is not in line with the government's policy goals (see, e.g. Alesina, Cohen and Roubini 1992). Siklos and Bohl (2005: 4) specifically identify inflation bias as the main source of conflict between the government and the central bank. Here, conflicts are more likely to take place when an economy is in a recession, because the government usually hopes for an easier monetary policy to boost the economy in order to strengthen re-election prospects. Another source of conflict is public communication by central bank officials.

The assumption that the government has to take sanctions on the central bank implies that the central bank is not a mere follower of the government's instructions. Rather, central banks can be regarded as active strategic players and central bankers cautiously contemplate the consequences of their actions by watching the political environment carefully in order to anticipate the reaction of markets and policymakers. This is regarded as an attempt to protect their independent position. The central bank's strategic behaviour can be distinguished into two categories. First, central bankers usually seek support for their policies, not only among policymakers, but also in the public. This can be accomplished in form of publications of economic data and monetary policy options (Berger 1997; Forder 1996; 45-47). Second, a central bank will typically avoid starting hopeless disputes with the Cabinet. In case the Cabinet enjoys sound support from the legislative, a central bank usually seeks to avoid working against the government's policy choices (Bernhard 2002: 58-59).[277]

The government and politicians can use threats to the central bank in order to signal their policy preferences.[278] One common threat is to change the central bank's institutional status if the central bank does not follow the government's preferences in economic policy. This can be done by means of a legislative order for the revision of the central bank statute. However, the threat to change the central bank's institutional status

additional variable, namely public support, a variable that may weaken the pressure exerted on the Bundesbank.

[277] Berger (1997) argues that the success of the German Bundesbank was often explained with the Bank's skilful ability to seek support for its monetary policies in the society and among politicians. In addition, conflicts with the government, which could threaten the bank's reputation, were selected cautiously by the Bank's authorities.

[278] In case of the U.S. Federal reserve, numerous studies demonstrate that lawmakers signal their preferences in monetary policy to their central banks. This can be done by means of the publication of statements or public complaints about present policies (Havrilesky 1988, 1995; Morris 2002).

usually requires cooperation between the Cabinet and legislature. If the Cabinet and legislature are divided, a threat to punish the central bank through a revision of the central bank's statute is not credible in most cases. This means that the central bank can play off the two principals by supporting only one principal, either the Cabinet or the legislature. If one veto player is satisfied by the central bank policies, any attempts to punish the central bank will be extremely difficult (Morris 2002). The existence of multiple veto players in the legislative procedure can weaken the power of policymakers to threaten the central bank (Lohmann 1998; Morris 2002). Morris and Munger (1998) argue that threats of sanctions by the principal are sufficient to make the agent follow the principal's preferences in economic policy. When applied to the U.S. and the Congress, this means that "bureaucratic agencies will never, *in equilibrium*, undertake an action that causes the Congress to impose sanctions. […] Congress performs no "active" oversight because it doesn't have to: the threat of ex post sanctions is sufficient to ensure ex ante compliance." (Morris and Munger 1998: 366).

However, some scholars have verified empirically that sanction measures by the government against the central bank are conducted only in rare cases (Bernhard 2002: 28-29). The central bank literature offers three reasons for this. First, politicians deliberately delegate monetary policy to independent central banks. Their unaccountable behaviour is totally accepted by politicians. Second, lawmakers are simply satisfied with the central bank's performance. Here, the central bank has anticipated the preferences of the government correctly, and follows them in order to prevent sanction mechanisms.[279] In other words, the government has no reason to punish the central bank. Third, sanction mechanisms, especially threats to revise the central bank Law, are politically costly for lawmakers. Thus, Woolley and LeLoup (1989) argue that threats by politicians to a central bank are hardly ever credible. This drives the conclusion that political oversight plays only a minor role in monetary policy making, regardless of the central bank's institutional status. The following sections focus on the Bank of Japan with the Japanese government and politicians with a principal-agent model.

[279] See, for example Calvert, McCubbins, and Weingast (1989), Lupia and McCubbins (1994), McCubbins, Noll, and Weingast (1989), McCubbins and Schwartz (1984).

8.3 The Relationship between the Bank of Japan and the Government under the New Bank of Japan Law

The new BJL requires the Bank to always "maintain close contact" with the government. This requirement makes it necessary that the BOJ communicate directly with politicians – a major change in comparison to the old BJL. Before the law revision, the BOJ communicated mostly with the MOF. A previous section demonstrated that the MOF acted as a "buffer" between the Bank and the government before the Bank of Japan Law revision. In contrast, under the new BJL, the BOJ is obliged to deal directly with the government, a completely new situation which many BOJ officials overextended. In comparison to MOF bureaucrats, politicians follow different incentives, and tend to have short-term goals towards, for instance, a low unemployment rate or a high growth rate that might conflict with the central bank's aim of price stability. Moreover, the average turn-over rate of politicians, in particular in Japan, is lower compared to MOF bureaucrats. These changes require BOJ officials to be able to rapidly adapt to new political environments. As a result of the direct interaction with politicians, the BOJ established a Diet Liaison Division which dealt with the Diet and the press. Moreover, a special senior BOJ official was appointed to advise the Governor regarding this issue (Bank of Japan 2002: 17).

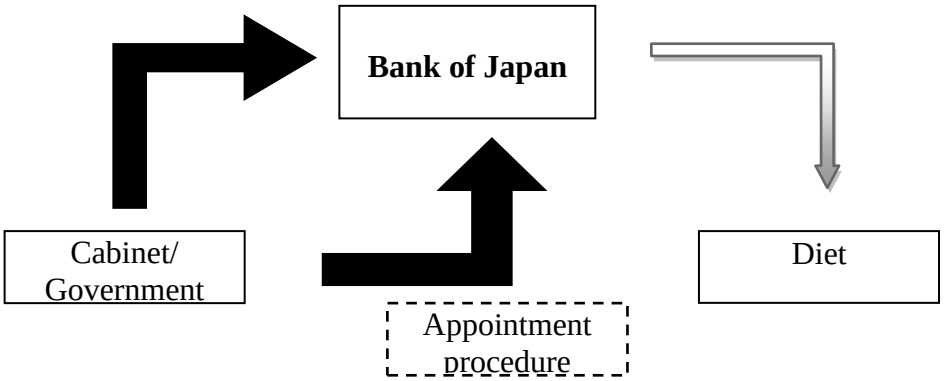
As the former sections demonstrated, the MOF was deprived of its former comprehensive legal power over the BOJ and monetary policy, and, thus, interactions between both organizations weakened. Most importantly, the MOF lost its permanent seat in the Policy Board. Instead, the Minister of Finance and the Minister of Economic and Fiscal Policy can attend the Policy Board meetings and express views. In addition, van Rixtel (2002: 248) notes that after 1998 the BOJ no longer assigned an *amakudari kanryô* from the MOF to the position of one BOJ Executive Director. In contrast, there are still numerous informal interactions between the BOJ and the MOF in relevant departments or divisions. Most prominent are informal exchanges of views before the BOJ Governor or other Policy Board members have to appear before the Diet. Pascha (2005a: 22) adds that apart from the usual interactions between the BOJ and the MOF, such as the attendance of government representatives in Monetary Policy Meetings and the attendance of the BOJ's Governor before the Diet on request, there is "a large number of informal consultations" (*sôdan*). Malcolm (2001: 93) argues the MOF

"maintained a modest degree of indirect control over the BOJ via the Bank's accountability to the Diet through the Finance Minister."

8.4 The Principal-Agent Relationship of the Bank of Japan and the Government and Diet

According to Chapter 2 about the theory of central banks, one adequate method for explaining the political economy of central banks is a principal-agent framework. As previously demonstrated one important point of change in the BJL revision was the relationship of the BOJ with the government (seifu) and the Diet (kokkai). Figure 8-1 and 8-2 compare the relationship of the BOJ with the government and Diet before and after the BJL revision in a principal-agent framework. The figures illustrate that the position of the Diet was strengthened in the new BOJ Law, including the Bank's obligation to be accountable before the Diet (see, Chapter 5). Before the revision, the relationship of the Bank of Japan had more characteristics of a single principal-agent relationship (Figure 8-1). The government had a high extent of power over the BOJ. It had the right to approve the budget of the BOJ (*yosan ninka*) (through the MOF), had a high extent of power over the Bank's operations (*gyômu meirei*) (through the MOF), and had the right to appoint the Governor (*sôsai ninmei*). The BOJ had to report to the Diet one time a year.

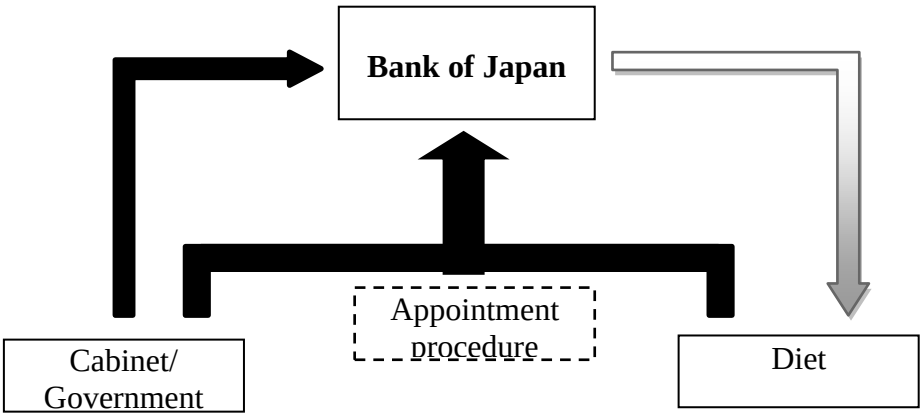
Figure 8-1: The Principal-Agent Relationship before the Law Revision



Source: Own illustration
Notes:
Black arrow: Put pressure on
White arrow: Is accountable to

Figure 8-2 shows that the principal-agent relationship between the Bank of Japan and the government and the Diet after the BOJ Law revision in 1998. Owing to the new BOJ Law, the relationship has changed towards a principal-agent framework characterized by multiple principals. Under the new BJL the Diet's approval is needed to appoint the BOJ's Governor, Deputy Governors and deliberative members of the Policy Board. In addition, the BOJ held even more accountable to the Diet than before as it is now required to report to the Diet twice a year. Moreover, the Governor has to appear before the Diet on request. According to the Bank of Japan Law, the Bank can conduct monetary policy independently. In terms of a principal-agent framework, this means that the agent has the first-mover advantage, and the principal can respond after the decision of the BOJ's Policy Board. In the new BJL the government's (executive) power has decreased. Nevertheless, it still can exert a substantial amount of pressure on the BOJ through three channels, namely the request to postpone a monetary policy decision, the approval of the BOJ's budget, and the request for special loans.

Figure 8-2: The Multiple Principal-Agent Relationship of the Bank of Japan after the Law Revision



Source: Own illustration
Notes:
Black arrow: Put pressure on
White arrow: Is accountable to

Regarding central bank accountability and a principal-agent framework, Oritani (2010: 32-33) argues that there are multiple principals, and that these represent the ultimate principal, the general public:

> ”Ultimately, the principal of a central bank is the general public. Indeed, it may be argued that the central bank is accountable not to the legislature, but to the general public. However, in a representative democratic system, the central bank is not a direct agent of the general public, but is formally an agent of the legislature or the executive branch. This goes to the heart of the problem of multiple principal agents. The formal principal (eg a government at the end of its mandate) may have incentives that lead it to misrepresent the interests of the ultimate principal (eg the public).”

Jabko (2009: 395) stresses the existence of multiple principals, and states that there is a recent trend towards increased central bank accountability (see, Chapter 6), in particular in the legislative branch: “Interestingly, the principle of legislative oversight is no longer really contested anywhere. Even when central bankers are independent from the executive branch of government, […] they [central banks] must publicly report […] to the legislative branch.” Similarly, the Central Bank Governance Group of the BIS (2009: 139-140) argues that:

> “Central banks are subject to a number of formal accountability arrangements. […] The legal foundations for central bank accountability tend to be specified in the constitution and the central bank statutes. […] Generally, central banks are formally accountable to the legislative or executive branch of government, depending on the constitutional delegation of responsibilities. […] For monetary policy, central banks have traditionally been formally accountable to the executive branch, in particular to the ministry of finance. Although this is still the case for a number of countries, central bank laws increasingly make the central bank accountable to the legislature.”

Political pressure can be applied through two different principals, the executive and the legislative. As the case studies will demonstrate, both principals have a wide arsenal of tools for exerting pressure and influence on the Bank of Japan. In the case of conflicts between the principal and the agent, the key question is how the principal can make the agent obey the principal. As Chapter 6 on “accountability” has demonstrated, the possibility of sanction measures by the principal is an important factor of an accountable central bank. Here, the independence of a central bank plays a role. Alpanda and Honig (2010) find that dependent central banks are more susceptible to political pressure to stimulate the economy before elections or to finance government

spending. According to this statement, it can be deduced that the BJL revision of 1998 freed the BOJ from the high degree of governmental pressure that had previously characterized the relationship between the BOJ and the Japanese government. The rervision had granted the BOJ a higher amount of central bank independence. However, this assumption turns out to be oversimplified, and the following sections will demonstrate exactly why this is the case.

This chapter focuses on two principals: the government (executive branch) and Diet politicians (legislative branch). This simplification allows us to exclude international pressure, e.g., from the US government and/or international organisations. It can be assumed that international pressure, if it occurred was aimed at Japanese politicians, and they, in turn, directed the pressure to the BOJ if it seemed appropriate to them. Pressure from the outside was mostly indirect, and only had influence on the BOJ if Japanese politicians used it to generate more pressure on the BOJ. The following chapters offer case studies regarding the appointment procedure of the BOJ (Section 8.5) and interference by the government in monetary policy (Section 8.7).

8.5 The Appointment Process

> "The procedures for identifying a new pope or a new Dalai Lama are less opaque than those which precede the appointment of a Chairman of the Federal Reserve, a Governor of the Bank of England or a President of the ECB." Davies (2005)

As stated in the introduction, one means of influence politicians use on the central bank is the appointment of the Governor, Deputy Governor, and Policy Board members (Chang 2003, Gilardi 2001: 12; Maxfield 1997: 32).[280] [281] [282] In contrast, Wilson (2000: 197-200) generally argues that a president who appoints a leader of a department or bureau usually does not seek to meet special goals with the appointment. Generally, the Prime Minister or the government have no clear plan as to which policy the appointee

[280] Empirical research on the U.S. Federal Reserve and the German Bundesbank showed that appointments of the central bank's key staff have influence on monetary policy (Chang 2003).
[281] Some political economists demonstrate that non-government appointees support tight monetary policy more often than do government appointees (Havrilesky and Gildea 1992). In addition, presidents repeatedly choose appointees with the aim to exert influence on monetary policy (Morris 2002; Waller 1992) and to please interest groups (Havrilesky and Gildea 1992).
[282] This drives the conclusion that principals might well be able to limit adverse selection problems through appointments, but they find it hard to solve ex post moral hazard by the appointees (Gilardi 2001: 12).

will follow in the future. After the appointment, Wilson characterizes the relationship between the principal and the agent as "somewhere between benign neglect and active hostility." However, as Capie et al. (1994: 55) point out "[p]eople in power normally appoint others to centres of power with whom they are comfortable. Hence, the appointment power is, of itself, likely to make the central bank subservient to the wishes of the government." Assuming the delegating authorities are driven by the incentive to establish a de facto independent central bank, they will appoint a Central Bank Governor with high leadership potential. However, the leadership quality of a certain candidate is difficult to determine in advance. Rather, a Governor's quality is visible only ex post through actual practice (Maxfield 1997: 32).

In this section the principal plays the main role, because the government is in the position to appoint the Governor of the central bank. However, the appointment of Policy Board members requires the consent of both houses of the Diet. The analysis of the rationale behind politicians' selection of particular Governors is the key question in this section. It can be argued that Japanese Prime Ministers, as the principals with the right to nominate candidates, can simply choose agents whose positions on monetary policy align with their own. However, due to the necessity of the Diet's approval, the appointment of a BOJ Governor is a very complex procedure.

One obvious finding is that the system of alternating Governor and Deputy Governor seemed to have changed with the new Bank of Japan Law in 1998, as all three Governors came from the BOJ until 2013 (Table 8-1). However, politicians did not necessarily mean to change the former system with alternating Governors between the BOJ and the MOF (see, Chapter 7). It was widely expected that Matsushita and Deputy Governor Fukui would fulfil their term until 1999, and that Fukui would take over the helm of the BOJ afterwards. However, the scandal of the arrested BOJ official Yoshizawa changed all plans, and, after the resignation of Matsushita and Fukui, a new candidate had to be found. It is ironic that this traditional system was only changed due to the emergence of a scandal (Yamawaki 2002: 250-260). In 2008, the Democratic Party of Japan, however, tried to put a final end to the debate about the system of rotating governorship. Several of the DPJ's policymakers opposed MOF-affiliated candidates for the post of Governor or Deputy Governor in 2008, making Shirakawa to the third successive Governor with BOJ background (Table 8-1).

Table 8-1: BOJ Governors and Deputy Governors after the Law Revision

Period	Governor	Affiliation	Deputy Governor	Affiliation
1998-2003	Hayami Masaru	BOJ	Yamaguchi Yutaka Fujiwara Sakuya	BOJ Jiji Press
2003-2008	Fukui Toshihiko	BOJ	Iwata Kazumasa Mutô Toshiro	Tôkyô University, Government[283] MOF
2008-2013	Shirakawa Masaaki	BOJ	Nishimura Kiyohiko Yamaguchi Hirohide	Tôkyô University BOJ

Source: Own illustration

The quote at the beginning of this section can be applied perfectly to the appointment process of BOJ Governors. This section analyses the appointment procedure of the three Governors who have been leading the BOJ until now, Hayami Masaru in 1998, Fukui Toshihiko in 2003, and Shirakawa Masaaki in 2008. In addition to the BOJ Governors, the appointments of the Deputy Governors, some deliberative members of the Policy Board and, very briefly, Executive Directors are investigated.

8.5.1 The Appointment Process in 1998

8.5.1.1 The Start of the Bank of Japan Law in 1998

Before the new BOJ Law took effect on 1 April 1998, the BOJ was involved in an unprecedented scandal which influenced the government's choice of the Governor and Deputy Governors. In 1997, BOJ officials had accepted lavish entertainment and gifts (*settai oshoku*) in exchange for information on interest rates. On top of the scandal, on 13 March 1998, the Head of the Capital Markets Division (*eigyôkyoku shôken kachô*) Yoshizawa Yasuyuki was arrested for accepting bribes in exchange for the disclosure of confidential information to executives of the Industrial Bank of Japan (IBJ) and the Sanwa Bank about the Bank's Tankan quarterly economic survey. After a thorough of investigation, almost one hundred BOJ officials were disciplined either in form of a warning (*keikoku*) or reprimand (*kenseki*). Two BOJ Executive Directors, Homma Tadayo and Kinoshita Eiichirô, resigned (Fujii 2004: 38-39; 63-65; Nakahara 2006: 23-32; Toya 2006: 201; van Rixtel 2002: 206-208).

[283] Iwata was a member of the Economic Planning Agency (EPA). In addition, he acted as a Cabinet advisor.

Taking responsibility for this scandal, Governor Matsushita Yasuo also resigned. The appointment of Matsushita, former Administrative Vice Finance Minister, in 1994 was possible because of the *amakudari* system of alternating BOJ Governors. However, he later faced harsh criticism due to the emerging "MOF bashing" (Chapter 4). Matsushita resigned in accordance with the traditional Japanese gesture of taking responsibility for the misconducts of subordinates, stating that "I feel grave responsibility as the head of the organisation [BOJ]". Later, it turned out that also Deputy Governor Fukui could not avoid his resignation.[284] Under normal circumstances, both terms of Matsushita and Fukui would have lasted until December 1999. That means, less than one month before the new BOJ Law took effect in April 1998, the Japanese government faced the difficult task of appointing a new Governor and Deputy Governor in a very limited period of time.

8.5.1.2 The Appointment of Governor Hayami

After the BJL revision influential LDP politicians requested a non-MOF Governor for the new Bank of Japan. After the exposure of the Yoshizawa scandal, these politicians were the driving forces behind the claim that Matsushita had to step down. For instance, Secretary General (*kanjichô*) Katô Kôichi and Nonaka Hiromu, Deputy Secretary General (*kanjichô dairi*) demanded a Matsushita to resign, arguing that it is inappropriate to have a former Vice Finance Minister as a BOJ Governor for the newly independent Bank of Japan (Fujii 2004: 37; Asahi 11 March 1998). Due to the strong pressure from these politicians, it was clear that Governor Matsushita had to take responsibility for the scandal and resign. The situation with Deputy Governor Fukui was different. Observers agree that under normal circumstances Fukui, who had filled all crucial posts at the BOJ throughout his career, would have been promoted to the next Governor (Arita 2007: 19; Fujii 2004: 17).

After the resignation of Matsushita, the general secretaries of the three party ruling coalition discussed the issue of BOJ Governor. One politician said that "Fukui was the only suitable candidate, but after the scandals there are problems [to select] him" (*tekininsha ha Fukui shi shika inai ga, nichigin naibu no fushôji ni sai shi, yahari mondai ga aru*) (Nikkei, 13 March 1998). However, government officials were

[284] In addition, Mieno, BOJ Governor from 1989 to 1994, resigned from his post as "honorary adviser" (*meiyo komon)* (Nikkei, 17 Mar 1998).

concerned that recent scandals could give opposition parties the opportunity to start a political battle against the Hashimoto administration if the Cabinet appointed Fukui (Kyodo, 12 March 1998). In addition, there were strong voices against Fukui within the LDP who opposed fiercely his promotion to Governor (*kiwamete tsuyoi hanpatsu*). At a LDP general meeting on 13 March 1998, many lawmakers argued against Fukui. For instance, Kamei Shizuka, former Minister of Construction, requested a Governor from the private sector. Similarly, Upper House Diet member Etô Takami stated that "since Governor Matsushita was only an outsider in the BOJ, the responsibility [for the scandal] belongs to the BOJ insider and Deputy Governor Fukui. A promotion of Fukui to Governor is out of question." This means that there was critique of Fukui from both the ruling parties and the opposition, which made his appointment to Governor impossible.

In sum, insiders from both the MOF and the BOJ were regarded as inappropriate choices by many, including the majority of politicians. In addition, in order to gain public support, the government needed a person without any scandals overshadowing his reputation (Arita 2007: 19). In the end, former BOJ Governor Mieno Yasushi, who originally was in favour of Fukui, recommended Hayami Masaru to former Prime Minister Takeshita Noboru. Takeshita then communicated this suggestion to Prime Minister Hashimoto. On 16 March 1998, Chief Cabinet Secretary Muraoka Kanezô announced that Prime Minister Hashimoto had selected Hayami to succeed Matsushita (Fujii 2004: 37-42; Nakahara 2006: 101), and four days later, the Cabinet appointed him BOJ Governor. Uchida Kenzo, Professor at Tokai University, called Hayami a "surprise nomination" (JT, 20 March 1998). Similar sentiments can be found in the Japanese press, for example, it was referred to as a "spontaneous decision" (*kyûten chokka*) (Asahi, 17 March 1998), an "emergency evacuation" (*kinkyû hinan*) (Fujii 2004: 42) or "only choice" solution (JT, 20 March 1998). The government "was not very happy with this choice", but Hayami was the only suitable candidate that could be found in the limited amount of time.[285]

Hayami Masaru, who spent 34 years in the BOJ, had worked mainly in the foreign department, including a tenure as chief representative in Europe. In 1978, Hayami was

[285] Interview with monetary expert, January 2010.

promoted to Executive Director. Nevertheless, the new Governor was not considered a BOJ insider, because he was never in the prestigious Policy Planning Department or Monetary Affairs Department, which were usually regarded as springboard for higher positions. Apart from working at the BOJ, Hayami had plenty experience in the private-sector. In 1981, he took a position at Nissho Iwai Corporation, a leading Japanese trading company. Between 1995 and 1998 Hayami acted as Chairman of the business lobbying group "Japan Association of Corporate Executives" (*Keizai Dôyûkai)*. Prime Minister Hashimoto commented that he "wanted someone who is well versed in international finance as well as the real economy [who] can deal with any debates ranging from international currency markets to the real economy" (Sprague 1998). Some sources assert that the choice of Hayami indicates that the government intended "to clean the bank of its scandal-tinted image", rather than selecting a monetary expert, for Hayami was not regarded as an expert of monetary policy (Arita 2007: 20; Fujii 2004: 49).

Several influential lawmakers made some positive remarks about Hayami's appointment. For instance, Finance Minister Matsunaga Hikaru stated, "[h]e [Hayami] is an extraordinarily fine man. [*hijô ni rippa na hito*] He has experience as BOJ executive and in foreign countries, he is fluent in English. He is a good choice for BOJ Governor." (Nikkei, 17 March 1998). Similarly, Horiuchi Mitsuo, METI Minister, said that "[Hayami] is a good personal decision. He is someone who frankly states his opinion, in the recent time a good [quality]".[286] Hayami had close contacts and enjoyed high reputations among private economists and in business circles (Sprague 1998). For instance, Toyoda Shôichirô, president of Keidanren stated that "Hayami is experienced in monetary affairs, has good connections to foreign countries. He is a good choice."[287] President of the Japan Chamber of Commerce and Industry (JCCI; *Nihon Shôkô Kaigisho*) Inaba Kôsaku said that "Hayami is a good choice as he has experience both within the BOJ and as private person. He is the perfect choice for BOJ Governor."[288] Other business leaders, including Imai Takashi, Vice president of Keidanren and

[286] In contrast, some influential lawmakers opposed the appointment of Hayami. Mori Yoshirô, then-LDP general secretary and Prime Minister between 2000 and 2001, was dead against Hayami. Mori was still angry that Hayami in the position of chairman of the *Keizai Dôyûkai* has supported the Hosokawa Cabinet and not the LDP in 1993.

[287] In Japanese: "*Kare ha kinyû ni mo kuwashii shi, gaikoku ni mo jinmyaku ga aru. Nichigin shusshin to itte mo, yamete kara daibu tatsu. Ii jinji da*."

[288] In Japanese: "*Hayami san ha, minkan to itte mo nichigin OB demo ari, chôdo nakama no you na hito…. Nichigin sôsai toshite ha tekinin de ha nai ka*."

president of Nippon Steel Corporation (*Shin Nippon Seitetsu*), Nasu Shô, president of Tôkyô Electric Power (Tôkyô denryoku), Nagano Takeshi, Mitsubishi Company and Shinagawa Masaji, from Nippon Insurance Company, similarly argued that Hayami was the appropriate choice (Asahi, 17 March 1998). In academic circles, Hayami was regarded as a person who can bring fresh air into the BOJ. For instance, Uchida Kenzo, Professor at Tokai University or Suzuki Yukio, Professor at Reitaku University agreed that Hayami was the right choice for BOJ Governor (e.g., Uchida Kenzo 1998: JT, 20 March 1998; Suzuki Yoshio 1998: 30 March 1998).

However, regardless of these individual positive voices the overall reactions after Hayami's appointment were not enthusiastic; mainly, because many observers were sceptical if the new BOJ under the leadership of Hayami would be able to act independently from the government, and financial markets first implemented a wait-and-see tactic to watch how the bank would conduct monetary policy under the new BOJ. According to the Economist (19 March 1998), it was widely believed that Hayami was appointed because politicians considered him as someone they could easily influence and exert pressure on. Thus, BOJ watcher Fujii (2004: 12) summarized that his feelings on the appointment of Hayami were mixed between "hope and fear" (*kitai to fuan*).[289] It can be concluded that Hayami was chosen as a compromise candidate between different interest groups.

8.5.1.3 The Deputy Governors

According to the new Bank of Japan Law, Article 16, Paragraph 2, the BOJ shall consist of two Deputy Governors, who shall be appointed by the Cabinet with the consent of both parliamentary houses (Article 23). This means the Japanese Government had to appoint two Deputy Governors after the resignation of Fukui.

On 20 March 1998, Prime Minister Hashimoto appointed Fujiwara Sakuya to Deputy Governor. This choice was a big surprise to many observers (Itô 2006: 106; Yamawaki 2002: 251). Fujiwara himself was truly amazed by his appointment, admitting that he continued to believe that his appointment was a "joke" (Fujiwara 1998; Fujiwara 2003b: 8-10). Many economists criticised this appointment, because Fujiwara was regarded as

[289] It has to be noted that Hayami would not have been appointed to Governor of the new BOJ without the corruption scandal in 1997 (Fujii 2004).

everything but a monetary expert (e.g., Iwata 2009: 36). Fujiwara, who had studied French literature, said about himself that he was poor in economics and even hated economics. Entering Jiji Press in 1962, he was disappointed that he was sent into the economics department and not the culture or foreign department (Fujiwara 2003b: 10-11). Although Fujiwara was reporting on issues regarding the BOJ in his position as a journalist for Jiji Press, and he was a member of the "journalist club of the BOJ" (*nippon ginkô no kisha kurabbu*) (Fujiwara 1998), Fujiwara bluntly admitted his weaknesses regarding economic issues, and he considered himself as an "amateur" (Fujiwara, 29 May 1998) or "complete layman" (*zubu no shirôto*) of monetary economics "who does not know the theory and practice" of financial issues. He stated, "I am old enough not to understand financial (instruments) […] such as derivatives"[290] (Asahi, 21 March 1998).

Similar to the appointment of Governor Hayami, the reason behind Fujiwara's appointment was to bring fresh air (*atarashii fû*) into the BOJ, in order to overcome the recent corruption scandal which resulted in the resignation of Governor Matsushita and Deputy Governor Fukui. The BOJ needed to regain credibility, and the government believed that a first step towards rebuilding its reputation could be accomplished with nominations of persons for the central bank's key staff who came from outside the BOJ. Thus, it can be argued that the unprecedented scandal within the BOJ facilitated the appointment of an outsider like Fujiwara (Fujii 2004: 43).[291] The government, facing pressure to nominate a candidate with a clean image, wished to appoint a person who could concentrate on the new, revised Bank of Japan (*nichigin kaikaku ni sennen*). The government trusted Fujiwara, who acted as a member of the MOF's FSRC with the task of BOJ Law revision (see, Section 3.5.7), to be a suitable person for the post of Deputy Governor (Fujiwara 2003b: 12-13). The slogan of "restoring of trust" (*shinrai kaifuku*) of the BOJ was the reason Fujiwara was chosen, and was his main task at the central bank. As the head of a special working group, Fujiwara's duty was to examine issues regarding legal compliance of BOJ officials. This group included Kamoshida Takayuki, BOJ Executive Director, the BOJ's audit office chief, and an external lawyer (JT, 28 March 1998).

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[290] In Japanese: "*Kinyû ni tsuite […] deribatibu mo rikai dekinai"*

[291] Originally, in preparation of shifting towards a system with two Deputy Governors, Nagashima Akira, BOJ executive from 1993 to 1998 was regarded of taking the post of Deputy Governor (Nikkei, 15 January 1998; Bank of Japan 1998, Minutes of MPM; Fujii 2004: 43).

Yamaguchi Yutaka, a career BOJ official, was appointed as the BOJ's second Deputy Governor on 1 April 1998. In contrast to Hayami and Fujiwara, his appointment was unanimously viewed as a good choice, and Yamaguchi was regarded as a highly respectable monetary expert. Yamaguchi's main task was the coordination of monetary policy operations and the handling of international relations (Nikkei, 21 March 1998). He regarded his task as "acting as a bridge between the staff of the Bank of Japan and the Policy Board" (Fujii 2004: 54; Yomiuri, 2 April 1998).[292] The Governor and the two Deputy Governors are called the "Executives" (*shikkô bu*) of the Policy Board.

8.5.1.4 The Policy Board

The key question regarding the design of the Policy Board is whether it supports the depoliticisation of the decision-making process. In fact, in comparison to the old regulations, the "new" Policy Board of the BOJ has essential differences and was depoliticised in many respects. The most striking depoliticization encompassed the termination of two government representatives as members of the Policy Board. However, under the new BOJ Law, two government representatives can join Monetary Policy Meetings. The composition of the BOJ's Policy Board changed significantly with the new BOJ Law. According to Article 16, Paragraph 2, the Policy Board shall consist of the Governor, two Deputy Governors and six deliberative members. That equals a total of nine members. After the Bank of Japan Law amendment of 1949, the Policy Board consisted of seven members, the Governor, four deliberative members, and two government representatives (Section 5.2.2.2). The major changes of the 1998 Bank of Japan Law in comparison to the old law can be seen in Table 8-2.

Table 8-2: The Policy Board of the BOJ before and after the Law Revision (According to the Bank of Japan Law)

	Policy Board (1949)	Policy Board (1998)
Governor	1	1
Deputy Governor	*	2
Other members	4	6
Government representatives	2	--
Total members	**7**	**9**

Source: Own compilation

[292] In Japanese: "*Nichigin sutaffu to seisaku iinkai no hashiwatashi ni tsutometai*".

Note:
* In the old BOJ Law, the Deputy Governor was not a member of the Policy Board.

The deliberative members changed significantly in the BOJ Law revision. While the four other members of the old law represented a specific field or Ministry (Section 5.2.1.2), the six members of the new Policy Board were required to be monetary experts, including academics.

Table 8-3: The Policy Board of the BOJ before and after the Law Revision (de facto)

	Bank of Japan Law 1942/1949	Bank of Japan Law 1998
Governor	Matsushita Yasuo	Hayami Masaru*
Deputy Governor	___	Fujiwara Sakuya Yamaguchi Yutaka
Other members	Koino Shigeru** Gotô Yasuo Taketomi Susumu ***	Gotô, Yasuo Taketomi, Susumu Shinotsuka, Eiko Miki, Toshio Nakahara, Nobuyuki Ueda, Kazuo
Government representative	Nakagawa Takanobu (EPA) Fujishima Yasuyuki (MOF)	___
Total members	**6**	**9**

Source: Own compilation
Notes:
* To be precise, Hayami was enacted as Governor already on 20 March 1998, ten days before the new BOJ Law took effect.
** The term of Koino Shigeru ended on 7 April 1998.
*** Since Ikura Kazuya (Shiga Bank) left the Policy Board in March 1996, the Policy Board consisted of only 6 members until April 1998.

Table 8-3 demonstrate that the changeover to the new Policy Board was a dynamic process. The board included members who were appointed under the old BOJ Law: Gotô Yasuo in 1995 and Taketomi Susumu in 1997. In a speech given on 9 June 1998 Gotô reports about his impression on the Policy Board under both the old and the new law. He welcomes the extension of deliberative members in the board, for different backgrounds of the individual members can lead to a better understanding and outcome of monetary policy.

However, the government's appointments of new Policy Board members can be seen as ambivalent.[293] Some members of the Policy Board, which included two outside economists (Ueda and Shinotsuka) and two industrialists (Nakahara and Miki), seemed to be more qualified by constituency than by expertise (Table 8-4). Iwata (2009) criticised the level of the BOJ's Policy Board in general, because many members are not monetary experts, and are poorly educated in comparison to international standards.[294] For instance, Shinotsuka Eiko,[295] former Professor of Labour Economics at Ochanomizu University, described herself as a "real layman" when dealing with financial economics (Fujii 2004: 30-32; JT, 2 April 1998).

Table 8-4: Affiliation of Policy Board Members (1 April 1998)

Policy Board member	**Affiliation**
Hayami, Masaru	Bank of Japan; Nissho Iwai Corp.; Keizai Dôyûkai
Fujiwara, Sakuya	Jiji Press journalist
Yamaguchi, Yutaka	Bank of Japan
Gotô, Yasuo	Ministry of Agriculture, Forestry, and Fishery
Taketomi, Susumu	Japan Industrial Bank
Miki, Toshio	Nippon Steel
Nakahara, Nobuyuki	Tônen Corp (Oil)
Shinotsuka, Eiko	Professor at Ochanomizu University
Ueda, Kazuo	Professor at Tôkyô University

Source: Own compilation based on Bank of Japan webpage

8.5.2 The Appointment Process in 2003

8.5.2.1 The Appoitment of Governor Fukui

The term of Governor Hayami ended in March 2003. When deliberating on a suitable successor for Hayami, politicians intensified their pressure on the BOJ during the last months of Hayami's term. Prime Minister Koizumi and several ministers, especially Economy Minister Takenaka Heizô, made no secret of their preference of a more aggressive monetary policy of the BOJ. Lawmakers repeated their demand for a harmonious policy between the government and the Bank, and openly showed that they

[293] It has to be noted that then-Deputy Governor Fukui had high responsibility in the composition of the Policy Board (Fujii 2004).
[294] Adolph (2004) confirms this view. Japan has only six per cent of Policy Board members with an advanced economic degree (only Ireland has a worse result).
[295] Fujii (2004: 30) reports that there were strong demands from the side of politicians to appoint one woman to the Policy Board.

had a strict preference for a Governor who would work aggressively to end deflation (*defure taiji ni sekkyokuteki na hito*), preferably someone who introduced an inflation target (*infure targetto*) (Hamada and Noguchi 2005: 39-41; Lukauskas and Shimabukuro 2006: 144-145; Katz 2003: 48). In short, the Prime Minister tried to make "sure that the BOJ under his leadership would cooperate with the government on the effort to end deflation." (Cargill and Sakamoto 2008: 121).[296]

Prime Minister Koizumi was known to have a preference for outsiders for government jobs.[297] It was also reported that he preferred to appoint an outsider from the private sector, e.g., a Professor or a business executive, for top positions in the central bank. The problem of appointing an outsider is that they may lack political ability. Some sources stated that Imai Takashi, former chairmen of Keidanren, was Koizumi`s favourite candidate. However, his support for Imai was not clearly stated, but rather characterized by an uncertain attitude, and Imai was not supported by the majority of the LDP (Fujii 2004: 29, 281-282). Later, many sources reported that Koizumi regarded former Policy Board member Nakahara as a possible candidate for Governor (Katz 2003: 48; Nikkei, 25 February 2003; Hamada and Noguchi 2005: 39-40). Nakahara, who was supported by LDP General Secretary Yamazaki Taku, would have been the worst choice for the BOJ, and the BOJ was alarmed when the name of Nakahara entered the agenda. Nakahara's view of monetary policy was the opposite of most central bankers (he constantly dissented from the Chairman's proposal for monetary policy during his term as Policy Board member from 1998 to 2002). The BOJ started a campaign to prevent Nakahara (*Nakahara soshi*) from being selected and to support former Deputy Governor Fukui Toshihiko (*Fukui suisen*) as Hayami's successor. Incumbent Governor Hayami said to Chief Cabinet Secretary Fukuda (LDP) that he recommended Fukui (*Fukui ni shite hoshii*). A good sign for the BOJ was that Nakahara did not gain much support from politicians and bureaucrats. A Governor who is close to the government and constantly dissents with the majority of the Policy Board would weaken the BOJ's credibility. Finally, Nakahara disappeared from the Prime Minister's list of suitable candidates for BOJ Governor (Fujii 2004: 281-286; Nikkei, 25 February 2003; Katz 2003: 48). In contrast, Fukui was supported not only by the Bank of Japan,

[296] Here, Wilson's (2000: 198-199) finding that a government appoints candidates of an organisation without achieving certain policy goals is not verified for the Japanese case.
[297] For instance, in 2001 Koizumi appointed the economist Takenaka Heizô to Minister of State for Economic and Fiscal Policy.

but also by influential politicians, most intensely by former Prime Minister Miyazawa and former Chief Cabinet Secretary Fukuda Yasuo (Lukauskas and Shimabukuro 2006: 146). Still, the government, Prime Minister Koizumi and particularly Economy Minister Takenaka were not convinced that Fukui was the best candidate.

However, Fukui, who previously worked as Deputy chairman of the Keizai Dôyûkai (Japan Association of Corporate Executives), had strong supporters from the private sector, e.g. Kobayashi Yôtarô of Keizai Dôyûkai and Okuda Hiroshi, chairman of Toyota and head of Keidanren, and Kobayashi Yôtarô, then-chairman of Keizai Dôyûkai (Katz 2003; Nikkei 25 February 2003; Fujii 2004: 283-284). Fukui, who enjoyed broad support in politics and business, was considered to be more flexible in monetary policy and more willing to cooperate with the government than Hayami (Iwamoto 2006; Katz 2003; Pascha 2005a, 2005b: 53).

Finally, Prime Minister Koizumi overcame his doubts about Fukui, and, on 20 March 2003, the government appointed him Governor. Koizumi states that "we have chosen a person who understands well the thinking of the government" (Nikkei, 25 February 2003). It was clear that the Prime Minister did not favour Fukui, but he had no better alternative. Fukui's attitude regarding fighting deflation was a factor that hindered Koizumi's full support of him. During his position as Executive Director of Fujitsu Research, Fukui published an article which revealed his strong opposition against inflationary measures. At a hearing at the Lower House Finance Committee meeting before his appointment on 18 March 2003, Fukui made cautious statements about the effectiveness of inflation targeting (Iwamoto 2006: 155). Generally, Fukui was regarded as an old fashioned BOJ man (furui taipu no chûô ginkô man) (Kanno, Nikkei 25 February 2003) who preferred to maintain the status quo. Other observers believed that Fukui would be as reluctant to ease monetary policy as his predecessor Hayami (Hamada and Noguchi 2005). Therefore, Fukui's nomination was connected with the impression of maintaining the current monetary policy, which was in opposition to the Prime Minister's reform plans. Koizumi intended to combine monetary policy and structural reforms to revive the Japanese economy.[298] Some critics believe that the selection of Fukui indicated that Koizumi's reform plans had been suppressed by LDP

[298] Koizumi's slogan was "economic recovery cannot occur without structural (fiscal) reform" (Yamamoto 2010; Bank of Japan 2001, MPM 17-18 May 2001).

politicians and bureaucrats. LDP lawmaker Yamamoto Kôzô (2010) critically stated that Koizumi ruined a perfect opportunity to make a policy change at the time of appointing a new Bank of Japan Governor by choosing the candidate that most closely represents the status quo, namely Fukui Toshihiko.

Nevertheless, there was hope that Fukui might take bold action against deflation pressures, and implement non-traditional monetary policies, including operations of buying exchange traded funds (ETF) and real estate investment trust funds (REIT) (Iwamoto 2006: 158-159). The government clearly stated what they expect from the BOJ under the leadership of Fukui, in particular in a meeting between Prime Minister Koizumi and Fukui on 14 March. Four days later, the Upper House of the Diet intensely questioned Fukui. Fukui was told that politicians expect bold actions against deflation. After having been in office for only five days, Fukui held his first Monetary Policy Meeting as Governor on 25 March 2003, the representative from the government's Cabinet Office remarked: "The Government considered that it was timely to hold this ad hoc Monetary Policy Meeting as the current situation was unpredictable. Moreover, the Government hoped that the Bank, headed by the new Governor and Deputy Governors, would conduct monetary policy to overcome deflation in closer coordination with the Government." (Bank of Japan, Minutes 25 March 2003).

Altogether, the appointment of Fukui was viewed as a "conservative choice" (*hoshuteki na sentaku*), or, according to Finance Minister Shiokawa Masajûrô as a "secure choice" (*antei shita jinsen*). Fukui was regarded to have strong ties to politicians (*seifu to no paipu wo futoku suru*) and the MOF (Nikkei, 25 February 2003). Besides Governor Fukui two Deputy Governors were appointed: Mutô Toshirô and Iwata Kazumasa.

8.5.2.2 The Deputy Governors

In general, Prime Minister Koizumi was looking for a team made up of a BOJ Governor and two Deputy Governors (*sannin setto*) who were against deflation (*defure taiji ha*). Most preferably, the three persons on the top of the BOJ should be a combination of one BOJ, one MOF and one private person (Fujii, Nikkei, 29 December 2002). While the appointment of Governor Fukui was not surprising to most observers, the appointments of the two Deputy Governors, Mutô Toshirô and Iwata Kazumasa, were considered astonishing and ambivalent.

Mutô acted as Administrative Vice Minister of the MOF between 2000 and 2003. He retained heavy influence in the ministry and had very close contacts in the Diet and with the country's technocrats, businessmen, and politicians[299] (Nikkei, 8 March 2008; Nikkei Weekly, 10 March 2008). Some observers argued that he was very close to Koizumi, and was titled as "Koizumi's wise man" (*Koizumi no chie bukuro*). Mutô strengthened the mutual relations between the MOF with the Prime Minister's office and other governmental ministries. In short, it can be argued that Mutô was the ministry's man inside the BOJ (Fujii 2004: 284-285; Posen 2004: 3; Katz 2003, Sugano Mikio [Nikkei 25 February 2003]). Finance Minister Shiokawa, who proposed the appointment of Mutô to Prime Minister Koizumi, said about his appointment that it is important to have a person within the BOJ who can transmit the position of the government to the BOJ. The Finance Minister expected a better cooperation between the government and the BOJ via Mutô (Asahi, 14 March 2003; Nikkei, 25 February 2003). Unsurprisingly, Mutô's appointment was strongly supported by the MOF. It was common knowledge that some highly influential people in the MOF wanted to regain some of the influence over the BOJ. Promoting and installing a former Vice Minister of Finance as Deputy Governor in the central bank was a promising way of guaranteeing just that.

The second appointed Deputy Governor was Iwata Kazumasa, who worked for the EPA from 1970 to 1985, before he received tenure as Professor of economics at Tôkyô University in 1986. Between 2001 and 2003, he held a position as a Cabinet Advisor (*naikaku fu seisaku tôkatsu kan*) in the Cabinet Office of Koizumi. Iwata was considered as more radical in comparison to Mutô regarding measures to overcome deflation and he was a proponent of introducing an inflation target. In various speeches concerning monetary policy, Iwata did not miss an opportunity to promote measures such as the extensive purchasing of JGB's in order to fight deflation more aggressively. Moreover, he seemed to support fiscal expansion and structural reform. In 2001, in his position as Cabinet advisor Iwata claimed that the BOJ should introduce quantitative easing measures (Nakahara 2006: 153). Iwata's most prominent supporter, who really pushed hard for his appointment, was Takenaka Heizô, the economic and financial-

[299] Interview with Bank official, 2008.

services minister. In short, Iwata was expected to be a "deflation fighter" (*defure faitâ*) and a supporter of the introduction of an inflation target (Fujii 2004: 285; Asahi, 25 February 2003; Nikkei, 12 March 2003).

Both Deputy Governors were "arguably aided in informal coordination with their former agencies" (Posen: 2004: 3), Mutô for the MOF and Iwata for the EPA. It was doubted that the BOJ could preserve its independence with a powerful man from the MOF inside the Bank (The Economist, 27 February 2003). Both kept close ties to politicians and their ministries during their terms as Deputy Governor. This means that none of the Deputy Governors originated from the BOJ. More precisely, Governor Fukui was the only one from the BOJ in the Policy Board (Table 8-5). It demonstrated how determined the government was to fight deflation. Regarding the central bank's independence, it can be argued that the selection of these two Deputy Governors weakened the independence of the BOJ. It can be argued that the government wanted to control and put pressure on Governor Fukui by means of the appointment of Mutô and Iwata. Finance Minister Shiokawa commented that "a person from the MOF is entering [the Policy Board], so we [the government] can manage a smooth policy" (*zaimushô shusshin sha ga iri, sumûzu na seisaku na unei dekiru*). (Nikkei, 25 February 2003). In short, the government demanded that Governor Fukui listen carefully to the opinions of Mutô and Iwata, in particular their ideas of non-traditional policies, in order to fight deflation more aggressively. The government expected much from the "new system" (*shin taisei*) of Governor and Deputy Governors. Economy Minister Takenaka stated that "the government and BOJ will be one system, each has to play its role in a reliable way to get out of deflation"[300] (Nikkei, 25 February 2003).

8.5.2.3 The Policy Board

The compilation of the Fukui-led BOJ's Policy Board is presented in Table 8-5 with the affiliation of each member. Next to the Governor and the two Deputy Governors, the Board consists of six deliberative members, including two academics (Ueda and Suda), one researcher (Taya), and three businessmen (Nakahara, Fukuma and Haru).

[300] In Japanese: "*seifu-nichigin ga itttai to natte defure kokufuku ni torikomu naka, otagai no yakuwari wo shikkari mitasanakereba naranai*."

Table 8-5: Affiliation of Policy Board Members (20 March 2003)

Policy Board member	Affiliation
Fukui, Toshihiko	Bank of Japan; 1998-2001 Fujitsu Research, 2001-2003 Keizai Dôyûkai
Mutô, Toshirô	Ministry of Finance
Iwata, Kazumasa	Cabinet office; Professor at Tôkyô University
Ueda, Kazuo	Professor Tôkyô University
Taya, Teizô	Daiwa Research Institute
Suda, Miyako	Professor Gakushûin University
Nakahara, Shin	Bank of Tôkyô Mitsubishi
Fukuma, Toshikatsu	Mitsui Corporation
Haru, Hidehiko	Tôkyô Electric Power Corporation

Source: Own compilation based on Bank of Japan's webpage

8.5.3 The Appointment Process in 2008

Governor Fukui's term ended in March 2008. The appointment process of the succeeding Governor Shirakawa Masaaki was exceptionally turbulent. The LDP lost the July 2007 election in the Upper House and the Democratic Party of Japan (DPJ, *Minshutô*) became the strongest party in the Upper House. This political development towards a twisted Diet (*nejire kokkai*) complicated the appointment of a new Governor and Deputy Governor. Legally, the appointment of the BOJ Governor requires the agreement of both houses (BJL, Article 23). The LDP party leader Fukuda Yasuo proposed several candidates, but many of them were rejected by the opposition-controlled Upper House until both Houses of the Diet agreed on Shirakawa.

8.5.3.1 The Process of Failed Appointment – Mutô and Tanami

On 7 March 2008, the Japanese government nominated incumbent Deputy Governor Mutô to Governor, and Itô Takatoshi, a Professor at the University of Tôkyô, and Shirakawa Masaaki, a former BOJ Executive Director to Deputy Governor (Table 8-6). Four days later, a Diet hearing in the Upper and Lower House for the three candidates took place. After the hearing, the Executive Committee of the DPJ decided to reject Mutô and Itô. On the next day, the DPJ-controlled Upper House only confirmed Shirakawa as Deputy Governor.[301] The following day, on 13 March, the Lower House

[301] In terms of legislation the House of Representatives can overrule a rejection by the House of Councillors with a two-thirds majority vote (Article 59 of the Constitution). However, this regulation is not valid for the appointment of BOJ's top positions such as the Governor, Deputy Governors, and

voted for all three candidates, but this vote had no impact as the approval of both chambers is necessary for appointing BOJ Policy Board members.

Before the DPJ became the largest party in the House of Councillors in July 2007, Mutô had been widely considered as succeeding BOJ Governor. Joining the BOJ as Deputy Governor in 2003, he had been prepped by Governor Fukui to be his successor. The rationale behind Muto's refusal was his 37 year long career at the Ministry of Finance. Between 2000 and 2003, Mutô served as Administrative Vice Finance Minister (*jimu jikan*), the highest rank for a bureaucrat. Some politicians from the opposition were concerned that a former MOF top man serving as the central bank's Governor would endanger the BOJ's independence. Candidate for Deputy Governor Itô Takatoshi notes that he was asked by Prime Minister Fukuda to become Deputy Governor on 6 March 2008. The reason for the DPJ and Upper House to reject Itô was his membership in the CEFP **(***Keizai zaisei shimon kaigi*), which was regarded as too close to the government by politicians from the opposition (Itô 2008).

The government's second candidate for BOJ governorship was Tanami Kôji, Governor of the Japan Bank for International Cooperation (JBIC, *Nihon kokusai kyôryoku ginkô*). However, Tanami was rejected for the same reason as Mutô, namely his former affiliation to the MOF. Tanami arrived at the MOF in 1964 and served as Vice Finance Minister from January 1998 to July 1999. In contrast, Nishimura Kiyohiko, a Policy Board member since 2005, was accepted as Deputy Governor and was appointed on 18 March 2008. As a result, when Fukui stepped down on 19 March, the BOJ was without an official leader, and was trapped in a so-called leadership vacuum (*lîdâshippu kûseki*). Deputy Governor Shirakawa took the position of acting Governor. That means the Policy Board of the BOJ was filled with only seven members instead of the required nine persons.

8.5.3.2 The Appointment of Governor Shirakawa

Early in April of 2008, Deputy Governor Shirakawa was nominated as Governor of the BOJ, and after the approval of the Upper House on 9 April, the stalemate over the leadership at the BOJ finally ended. However, Watanabe, a nominee for the position of

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Monetary Policy Board members. Article 23 of the Bank of Japan Law requires the approval of both Diet chambers.

Deputy Governor, was blocked by the DPJ. The opposition disapproved Ikeo Kazuhito, a Keio University Professor, and another candidate for the Policy Board. Ikeo was nominated on 29 May 2008, and the Lower House endorsed him on 12 June. However, on 23 June the government withdrew the nomination after the opposition announced that they would reject him in the Upper House. It should be noted that the DPJ basically endorsed Ikeo, but another opposition party, the People's New Party (Kokumin Shintô), were against him. Ikeo did not have direct ties to the Ministry of Finance, but used to be a member of the government's Financial System Council (FSC). Until October, the BOJ had only one Deputy Governor, until finally Yamaguchi Hirohide was approved by both Houses of the Diet and appointed on 27 October 2008. Table 8-6 summarizes the complicated process of appointment of the BOJ Governor and Deputy Governors in 2008.

Table 8-6: The Appointment Process in 2008

Nomination	Governor	Deputy Governor	Upper House	Lower House	Appointment
7 March	*Mutô*	*Itô* Shirakawa	12 March	13 March	20 March
18 March	*Tanami*	Nishimura	19 March	19 March	20 March
7 April	Shirakawa	*Watanabe*	9 April	9 April	9 April
15 October		Yamaguchi	24 October	24 October	27 October

Source: Own illustration
Note: The candidates marked in italics were rejected by the Upper House

The procedure of appointment of Governor Shirakawa leads to the question why so many candidates have been rejected by the opposition, and why the government kept on proposing candidates who the opposition would not endorse. This issue will be investigated in the following sections.

8.5.3.3 The Standpoint of the Opposition – The Democratic Party of Japan

The Democratic Party of Japan (DPJ), in particular in the party leader Ozawa Ichirô, had previously announced that they would reject all candidates with a MOF background for BOJ Governor and Deputy Governor. According to Lukauskas and Shimabukuro (2006: 3), the DPJ and other opposition parties intended to break the high degree of influence of the MOF over the BOJ and its monetary policy. Basically, the majority of the DPJ promoted a separation of fiscal and monetary policy (*zaisei kinyû bunri ron*). In

this regard, the DPJ's political indisposition against Mutô was no surprise to observers. Generally, the DPJ was well-known for their anti-bureaucratic stance (Sasaki 2002: 103). It must be noted that various DPJ politicians, for instance General Secretary Hatoyama Yukio and Vice President Naoto Kan, already argued critically against Mutô in 2003 when he was nominated as Deputy Governor. However, because the LDP-led coalition enjoyed the majority in both houses of the Diet at that time, Mutô became Deputy Governor in 2003. However, Hatoyama repeated his resentment against the appointment of Mutô in 2007 (Nikkei, 11 August 2008), and, in 2008, the DPJ used its majority in the Upper House to reject him.[302] Thus, it was no surprise for the ruling parties that Mutô was rejected by the Upper House.

Politicians from the Upper House argued that appointing candidates from the MOF to a top position in the central bank would make the central bank subservient to the Ministry, as it was before the BOJ Law revision.[303] MOF-affiliated Governors or Deputy Governors could exert intense pressure on the BOJ to support the government in managing the massive Japanese government debt, and, eventually threaten the central bank's independence. However, the DPJ's viewpoint remained incongruent and enigmatic. DPJ party leader Ozawa Ichirô stated that:

> "[w]e [the DPJ] are not opposed to finance ministry officials holding jobs at the central bank, as this is common in other countries as well, but rather we are against fixed positions being reserved exclusively for such officials." (Rial 2008).

Despite Ozawa's statement, the opposition controlled Upper House rejected all candidates with a background from the MOF or other governmental institutions (Table 8-6). For instance, during Muto's hearing in the Diet, DPJ lawmakers criticized the BOJ's quantitative easing policy during which the bank purchased high amounts of government bonds. Somewhat inconsistent is that the DPJ itself proposed and supported this policy measure as a tool to fight deflation before. Moreover, it was common knowledge that Sengoku Yoshito, former DPJ policy chief, was dead against Mutô, but Ozawa, the DPJ party leader, was willing to consent and to accept him. In addition, with

[302] In contrast, other sources assert that DPJ's Ozawa was willing to accept Mutô (Japan Echo, Nikkei Shinbun).
[303] The chair of the Financial System Research Council Tachi Ryûichirô hold the viewpoint that former MOF officials should not be restricted to take the helm of the BOJ when they are the most appropriate candidates (Ziegler 1998: 604).

the rejection of Watanabe Hiroshi, the case is even more unclear. Whereas Ozawa criticized the nomination of Watanabe as an act of *amakudari* (descent from heaven), other politicians in the DPJ were willing to accept him as a compromise candidate due to his international experience, including Maehara Seiji and Hatoyama Yukio, who candidly declared that he disagrees with Ozawa[304] (Shiraishi 2008).

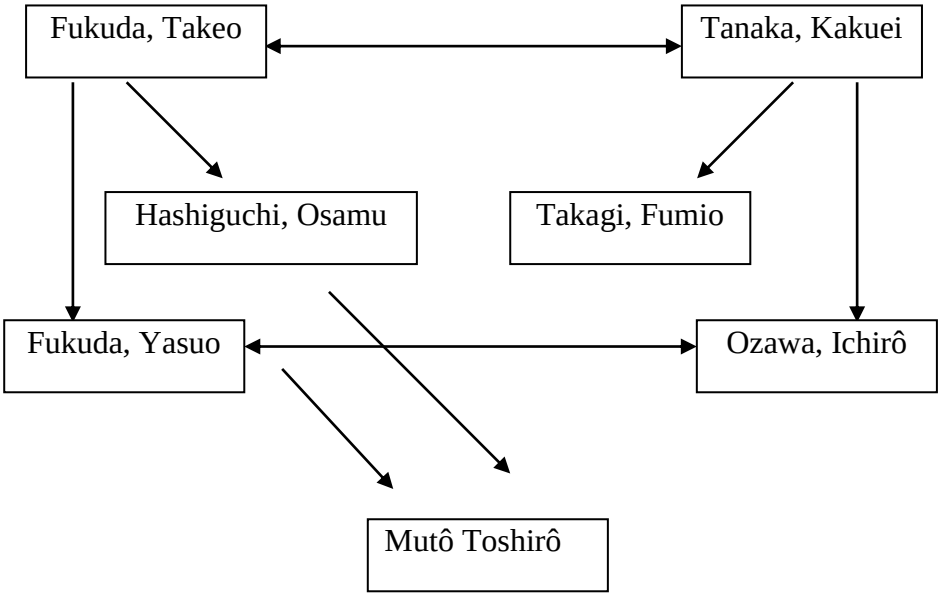
8.5.3.4 The Standpoint of the LDP and Prime Minister Fukuda

Why did the LDP and Prime Minster Fukuda insist on candidates for BOJ Governor and Deputy Governor who have been affiliated with the MOF? The Prime Minister's strategy seemed dubious. After the opposition rejected Mutô, DPJ politicians made it very clear that they would not accept any candidates from the MOF. However, Fukuda stuck to his strategy to nominate candidates who had their origin in the Ministry. That is why most observers blamed the Fukuda-led LDP for the leadership vacuum in the BOJ in March of 2008. The Fukuda Cabinet was characterized by a strong influence from the MOF (as it was with the Koizumi Cabinet) (Uekusa 2008). This helps to explain why Prime Minister Fukuda tried to push MOF candidates to the helm of the BOJ, although there were strong signs that they would be rejected by the opposition.

Regarding the nomination of Mutô, there circulates an additional explanation for Fukuda's behaviour.[305] Prime Minister Fukuda wanted to pay the debts of his father Fukuda Takeo, Prime Minister from 1976 to 1978. Tanaka Kakuei, Prime Minister from 1972 to 1974, and Fukuda Takeo were fierce rivals, and involved in an intense power struggle over the control of the LDP (the so-called Kaku-Fuku War). In 1974, Tanaka was Prime Minister and Fukuda was Finance Minister. Regarding the post of Vice Finance Minister (*Ôkura jimu jikan*), Fukuda wanted to appoint Hashiguchi Osamu, whereas Tanaka preferred Takagi Fumio. After a long struggle, Tanaka was successful and Takagi was appointed to Vice Finance Minister. Later, Hashiguchi's daughter married Mutô Toshirô. With the promotion of Mutô to BOJ Governor Fukuda Yasuo could have repaid the "old debts" for the failed attempt of his father to have Hashiguchi implemented. However, Ozawa Ichirô was a prodigy of Tanaka, and tried to prevent the promotion of Mutô and other MOF-affiliated candidates (Figure 8-3).

[304] Interview with former BOJ official, 2008.
[305] Interview with former BOJ official, 2008.

Figure 8-3: The Continuation of the "Kaku-Fuku War"



Source: Own illustration

8.5.3.5 Governor Shirakawa

The previous sections have demonstrated that Shirakawa Masaaki became BOJ Governor rather by incident. However, Shirakawa's expertise on monetary policy is highly respected and most analysts considered him as well-suited for the post of Bank of Japan Governor, although some observers worried about his poor political skills (e.g. Sano 2008). Jacob Frenkel, a former Bank of Israel Governor and Shirakawa's teacher at Chicago University, regarded this point as an advantage for the new Governor, stating that "Shirakawa wasn't a candidate of any political party. He doesn't owe anybody anything." (Clenfield 2008). However, despite his poor political skills when he was appointed, Governor Shirakawa managed to build favourable relations with the government, including regular discussions with the Prime Minister, during his tenure. These relations have helped him to absorb some pressures to implement stronger policy measures against deflation. The compilation of the Shirakawa-led BOJ's Policy Board is presented in Table 8-7 with the affiliation of each Policy Board member. Suda, re-appointed in 2006, was the second academic in the Policy Board together with Deputy Governor Nishimura. Four members were businessmen (Mizuno, Noda, Nakamura and Kamezaki). Governor Shirakawa and Deputy Yamaguchi were long-time BOJ

employees. Due to the confrontations in the appointment process between the government and the Upper House of the Diet, there was a vacancy in the Policy Board, and the Board consisted only of eight members. It was not until the appointment of Morimoto Yoshihisa on 1 July 2010 that the Policy Board was completed.

Table 8-7: Affiliation of Policy Board Members (20 March 2008)

Policy Board member	**Affiliation**
Shirakawa, Masaaki	Bank of Japan; Professor Kyôto University
Nishimura, Kiyohiko G.	Professor Tôkyô University
Yamaguchi, Hirohide*	Bank of Japan
Suda, Miyako	Professor Gakushûin University
Mizuno, Atsushi	Nomura Securities
Noda, Tadao	Daiichi Kangyô Bank; Mizuho Bank
Nakamura, Seiji	Mitsui Corporation
Kamezaki, Hidetoshi	Mitsubishi Corporation

Source: Own compilation based on Bank of Japan webpage
Note:
* Yamaguchi started his tenure on 27 October 2008. Before that the BOJ had only one Deputy Governor.

8.5.4 Appointments to the Policy Board and Executive Directors

The previous sections focused on the appointment of the Governor and Deputy Governors. This short section offers some examples of appointments of deliberative Policy Board members and Executive Directors.

In October 1999, the term of Policy Board member Gotô Yasuo, who was a former bureaucrat at the Ministry of Agriculture, Forestry, and Fishery and who was appointed together with Taketomi Susumu under the old BOJ Law in 1995 and 1997 respectively, ended. The BOJ unsuccessfully tried to work towards a re-appointment of Gotô. Although there was no objection from the MOF and the government, the re-appointment failed over an agreement by the ruling and opposition parties to avoid candidates with an age over 70 years (Fujii 2004: 132-133). Later, Hayami promoted the appointment of Mizuguchi Kôichi, former vice chairperson of Keizai Dôyûkai, whereas others in the BOJ promoted Ogura Kazuo, former ambassador of France (Nakahara 2006: 84-90). However, both the BOJ and Hayami lost the battle in promoting their favourite candidate. Gotô's successor was Taya Teizô, an economist of Daiwa research and a former IMF economist. Taya was appointed in December 1999 after an almost two

month vacancy in the Policy Board. There was a rumour that the appointment of Policy Board member Taya was strongly demanded by the MOF (Nikkei, 7 December 1999) and that the two months vacancy was caused by a quarrel between the MOF and BOJ. EPA Minister Sakaiya recommended Taya to Finance Minister Minister Miyazawa, who had close ties to Taya. The Finance Minister finally informed Hayami (Fujii 2004: 136-137). Policy Board member Nakahara Nobuyuki, who had close connections to Prime Minister Obuchi, recommended the appointment of Taya as Taya seemed to be in favour of unorthodox policies and monetary easing. Nakahara has hoped to find an ally in the Policy Board for the promotion of quantitative easing policy.[306]

To prevent a simultaneous exodus of all Policy Board members, the four Policy Board members who started their tenure in April 1998 were awarded different length of tenures. This rule was installed in order to prevent the ruling party or the Diet from replacing four members of the Policy Board with candidates who may share similar views at the same time. Nakahara and Miki received a four-year term, Shinotsuka a three-year term and Ueda a two-year term. Both had the possibility of re-appointment. However, when Shinotsuka's three-year term ended on 31 March 2001, the government was not willing to re-appoint her. As the strongest hawk in the Policy Board, she persistently argued against the government's viewpoint, but rather proposed tighter monetary policy and the termination of the zero interest rate policy (Section 8.6.5). Unsurprisingly, the BOJ argued in favour of Shinotsuka's re-appointment, but she received no support in the government, and, finally only served the first three years (Fujii 2004: 185-186).

Executive Directors also belong to the central bank's key staff. According to Article 23, Paragraph 4 of the BOJ Law, the Ministry of Finance has the right to appoint Executive Directors based on recommendation made by the Policy Board. The task of Executive Directors is to manage the business of the Bank and to assist the Governor and Deputy Governors (BJL, Article 22, Paragraph 5). As seen in Chapter 5, one Executive Director was a former MOF bureaucrat under the old BOJ Law. After the new BOJ Law took effect on 1 April 1998, it was thought that Yonezawa Junichi who was Executive

[306] However, Nakahara's plan failed. In his first three Monetary Policy Meeting (17 December 1999, 17 January 2000, 10 February 2000), Taya abstained from voting to the proposal of Nakahara towards the introduction of quantitative easing policy. After that Taya changed his mind and voted against Nakahara.

Director until 31 May 1998, was the last Executive Director with MOF origin. However, on 15 December 1998, Finance Minister Miyazawa appointed Nagata Shunichi as BOJ Executive Director. Nagata was a high-ranked MOF official, and very close to the government. In 1996 and 1997 he acted as a member of the BOJ's Policy Board. In addition, Nagata joined Monetary Policy Meetings between 1999 and 2002 as reporting staff. The appointment of Nagata to Executive Director in 1998 was somewhat delicate, and has demonstrated that the old tradition of one Executive Director from the MOF was not abandoned completely. The move to appoint Nagata to Executive Director clearly enhanced the influence of the MOF on the BOJ (Fujii 1999).

The previous subchapters have presented the appointment procedure of BOJ staff by the government. In general, it can be summarised that disputes over appointments of BOJ officials – not only the Governor and Deputy Governors – have become much politicized, especially in recent times. The following chapter will investigate the second issue of political influence, namely governmental interference in monetary policy decisions. First, an overview of the monetary policy developments since 1998 will be presented, and, afterwards, the political pressure on the BOJ will be elaborated in detail.

8.6 The Bank of Japan's Monetary Policy Decisions

8.6.1 Introduction

Interference in monetary policy decisions is the second channel of political influence. This channel requires two conditions to be effective. First, central bankers must be office-seeking. Second, politicians need to have sanction instruments to exert pressure on the central bank (Mueller 2008: 6). That is, a central bank is not operating in a political vacuum even when it is independent from the government.[307] Freytag (2002: 2) argues that:

> "[m]onetary policymakers do not operate in isolation from other politicians, bureaucrats and interest groups. On the contrary, they have to bear permanent pressure to increase money supply and thereby support the government in fulfilling its task."

In this section, the agent is the main actor, because according to the Bank of Japan Law, the Bank can conduct monetary policy independently (BJL, Article 3). The principal can

[307] Goodfriend (2005: 83-84) discusses some specific examples of how independence exposes the Fed to external pressure that is potentially counterproductive for good monetary police. For instance, politicians and the public often pressure the central bank to keep interest rates low.

express its concern and make monetary policy suggestions in the Policy Board (BJL, Article 19, Paragraph 2), and exert pressure on the Bank, but the Policy Board of the BOJ has the final word in setting monetary policy decisions. This section analyses monetary policy decisions of the BOJ since 1998, and provide some case studies to investigate how the main actors - the BOJ, the government and Diet politicians - acted and interpreted the new BOJ Law. For instance, considerable attention is paid to the monetary policy decision to end the zero interest rate policy in August 2000. Several politicians expressed strong objections against that move and therefore this issue is a very good example upon which to study the different viewpoints of the principal and the agent. This section demonstrates that regardless of the new BOJ Law which granted the BOJ independence, political pressure on the BOJ continued as if the central bank statute had not been changed.

This section takes stock of some key decisions in monetary policy from 1998 to 2006, including the decision to introduce the zero interest rate policy in February 1999. Second, the decision to end the zero interest rate policy and raise the interest rate in August 2000 is also of interest. The following issue is the introduction of the quantitative easing policy in March 2001, followed by the decision to end the quantitative easing policy in March 2006. These issues will be investigated in chronological order in regards of the political economy of an independent central bank.

8.6.2 The Zero Interest Rate Policy

Approximately half a year after the inauguration of the new Bank of Japan Law, the BOJ reacted to the problem of a deteriorating Japanese economy, and decided to cut the interest rates to 0.25 per cent in the Monetary Policy Meeting on 9 September 1998. This was the first rate cut in three years. This decision was made by means of a majority vote, only Policy Board member Shinotsuka opposed. In the beginning of the following year, confronted with strong government pressure, the BOJ Policy Board announced to cut the key interest rate further, to a level as low as possible, and the so-called zero interest rate policy (ZIRP, *zero kinri seisaku*) started on 12 February 1999. Generally, the aim of the zero interest rate policy was to rebuild the financial sector through the channel of “cheap credits” in order to support the aggregate demand and to stop deflation pressures. Deputy Governor Yamaguchi (2001) stated that:

> "the strength of the zero rate has partly to do with the then-prevailing extreme fragility of Japan's financial system and markets where liquidity was drying up. The banks with insufficient capital base were facing a serious liquidity shortage. The zero interest rate policy forcefully supplemented the effect of the public injection of capital by its strong liquidity effect."

At a press conference on 13 April 1999, Governor Hayami tried to clarify what the BOJ understands by zero interest rate policy. He stated that: "until we reach a situation in which deflationary concerns are dispelled, we will continue the current policy of providing necessary liquidity to guide the uncollateralized overnight call rate down to virtually zero per cent while paying due consideration to maintaining the proper functioning of the market." [308] According to Taylor (2001: 47-48), Hayami's announcement in April towards a clarification of the zero interest rate policy was a kind of "contingency plan", explaining "under what circumstances interest rates will change in the future." Ueda, member of the Policy Board, explained that "[b]y the commitment to maintain the zero rate for quite some time to come we [the Policy Board] have tried to minimize uncertainties about future short rates, thereby decreasing the option value of long-term bonds, hence putting negative pressure on long-term interest rates." (Ueda 2000: 1107). Simply put, the zero interest rate policy was characterized by a combination of a zero short-term interest rate and the commitment to maintain it until deflationary concerns were dispelled. In other words, two conditions were essential for the zero interest rate policy to be effective, namely the "quantity" of money and the "policy duration" (Baba et al. 2006: 106; Fujiki and Shiratsuka 2002).

8.6.3 Monetary Policy Stance of Policy Board Members

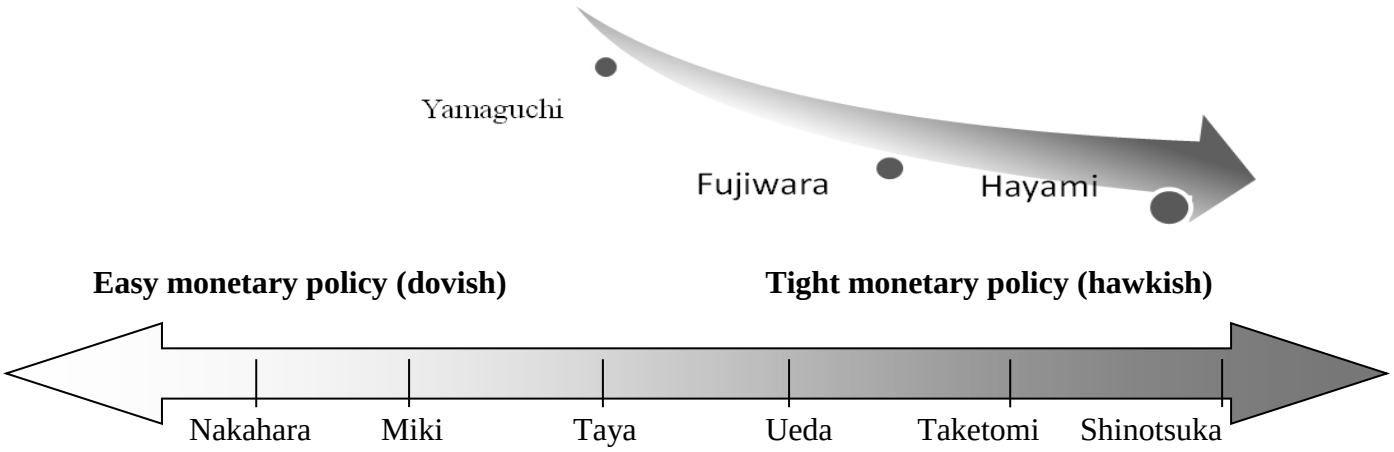
Arguably, the Governor is the key person of the central bank regarding the decision-making of monetary policy. However, Blinder argues that:

> "[m]y experience as a member of the FOMC left me with a strong feeling that the theoretical fiction that monetary policy is made by a single individual maximizing a well-defined preference function misses something important. In my view, monetary theorists should start paying attention to the nature of decision making by committee, which is rarely mentioned in the academic literature" (Blinder 1998: 22).

[308] Bernanke (2000: 159) argues that the phrase "until deflationary concerns are dispelled" is problematic since the BOJ did not give a clear answer what this exactly means.

Rather than focussing excessively on the Governor, the whole monetary policy decision body needs to be investigated to gain a deeper understanding as to why certain monetary policy decisions took place. It is necessary to investigate the monetary policy stances of all Policy Board members, for the Policy Board consisted of very different individuals with strongly differing opinions concerning monetary policy (*shiniin ha koseiha zoroi*) (Nikkei, 8 May 1998). Figure 8-4 demonstrates the diversity of opinions of the new Policy Board.

Figure 8-4: Monetary Policy Preferences of Each Monetary Policy Board Member in 1999



Source: Own compilation based on Oshio (2000)

The strongest proponent of easing monetary policy (*kanwa ron sha*) was Nakahara Nobuyuki. Shinotsuka was on the other end, representing the most hawkish stance (*hikishime ron sha*) when it came to monetary policy. Interestingly, the Policy Board's Executive Committee (*shikkô bu iin*), Governor Hayami, Deputy Governors Fujiwara and Yamaguchi followed the same monetary policy strategy throughout their whole time in office (Fujii 2004: 54-56), and the Deputy Governors never opposed Governor Hayami's monetary policy proposals. Figure 8-4 shows that the members of the Policy Board can be distinguished into five groups. Parallel to FOMC watchers who distinguish between monetary hawks and doves, BOJ watchers categorize BOJ Policy

Board members either as "hawks" (*taka ha*) or "doves" (*hato ha*) (Oshio 2000: 192-193).

i) Monetary hawk (taka ha) (Shinotsuka)
ii) BOJ executives (Hayami, Fujiwara, Yamaguchi)
iii) Close to the BOJ executives (Taketomi, Ueda, Gotô [until October 1999])
iv) Proponents of easier money (Miki,Taya [since December 1999])
v) Aggressive easing (hato ha) (Nakahara)

It can be argued that there was a Nakahara-pattern in the Policy Board. That is that Nakahara constantly dissented from the chairman's proposal. In addition to this, he continuously formulated an own monetary policy proposal towards aggressive monetary easing. However, Nakahara rarely found supporters for his policy proposals, and was isolated in the Policy Board.[309] In contrast, Policy Board member Shinotsuka's policy stance, although also isolated in her proposals to tighten monetary policy, was closer to that of the BOJ executives, meaning her policy proposals found general acceptance in the BOJ. The zero interest rate policy was not very popular among BOJ circles, and Governor Hayami tried to abandon this non-traditional monetary policy measure as soon as possible.

8.6.4 Preparation for the Termination of the Zero Interest Rate Policy

Governor Hayami and the Policy Board were worried about undesirable side effects of the zero interest rate policy (*zero kinri no fukusayô*) and since the Monetary Policy Meeting on 18 May 1999, Policy Board members have discussed how to deal with side effects of zero interest rate policy in detail, especially the moral hazard problem. This indicates that members of the Policy Board were very concerned about zero interest rate policy.[310] Since the end of 1999, Policy Board members have started to take an optimistic view on the condition of the Japanese economy. In the Monetary Policy Meeting on 17 January 2000, some Policy Board members raised the question whether

[309] The nomination of Nakahara – and most of other members of the Policy Board – was arranged and managed by then-Deputy Governor Fukui. It was known to Fukui that Nakahara had different opinions of monetary policy and had an uncompromising character (Fujii 2004: 17-26).
[310] For instance, Policy Board member Shinotsuka Eiko was the most hawkish member of the Policy Board (see, Figure 8-4). Already since May 1999 she officially suggested to end zero interest rate policy and to raise the interest rate to 0.25 per cent in every Monetary Policy Meeting, except the four meetings between September and October 1999. However, Shinotsuka's suggestions were all voted down by one in favour and eight against.

deflation worries had been expelled (*defure kenen fusshoku*). A Policy Board member stated:

> ”Japan's economy, which has stopped deteriorating, has recently started to improve, with exports and production increasing. The economic environment surrounding private demand is gradually improving, as seen in the continuing increase in corporate profits” (Bank of Japan, MPM 17 January 2000).

Since April 2000, based on the results of own publications (e.g., The Monthly Report), the BOJ believed that the Japanese economy was recovering, and started to work towards an end of the unpopular zero rates. Most Policy Board members were convinced it would be best to terminate zero interest rate policy at the soonest possible time. In the Monetary Policy Meeting on 12 April 2000, on basis of the April Tankan report, Policy Board members argued that in terms of the termination of the zero interest rate policy the question was not if, but rather when the time of the termination was approaching. When Policy Board member Nakahara told Finance Minister Miyazawa about the intention of the Policy Board to end zero interest rate policy soon, the Minister reacted very irritated (Nakahara 2006: 99-100). In a press conference on 12 April 2000, Governor Hayami announced that the majority of the Policy Board was against the maintenance of the zero interest rate policy for too long. The Policy Board was carefully watching economic conditions, and, in case of a continuation of economic recovery, the BOJ would end this policy (Bank of Japan, press conference, 12 April 2000). In preparation for ending zero interest rate policy, Hayami justified his upbeat view on the Japanese economy by stating:

> “What I see as good news in the economy is the ongoing structural restructuring in the private sector. We are seeing a creative destruction movement, in which corporations have been getting rid of old equipment and making new investments and promoting innovation in their activities. It is this restructuring and reengineering movement in the corporate sector, including the spread of information technology that I see as a bright sign.” [sic] (Interview with Hayami, Business Week, 12 June 2000).

Not only Hayami, but the majority of the Policy Board had an optimistic view of the Japanese economy. For instance, Deputy Governor Yamaguchi stated that “it is now pretty safe to assume this economy will record positive growth, somewhat above the 1% growth projected by the government” (Business Week, 12 June 2000). In an interview given on 14 April 2000, Yamaguchi said that the economic recovery had become clear

(Nakahara 2006: 112). In addition, Yamaguchi emphasized an improvement of deflation problems: "as I [Yamaguchi] understand the situation, prices have become relatively stable. The wholesale price index in the last month was up half a percentage point from 12 months ago" (Business Week, 12 June 2000).

Due to the BOJ's communication strategy, the market was fully aware of the possibility of a rate hike.[311] There was widespread speculation that the BOJ was intending on raising interest rates as early as the meeting on 17 July (Iwasaki, Nikkei 28 June 2000), and Policy Board member Nakahara (2006: 117) believed that the BOJ's executives had prepared for a termination of the zero interest rate policy. Although the BOJ wanted to increase interest rates at the July 2000 Monetary Policy Meeting, the Bank was surprised by the collapse of the department store chain Sogô and decided the monetary policy should remain unchanged (Itô 2006: 112; Fujii 2004: 158-159; Nakahara 2006: 117-124).[312] The financial markets were confused by this decision. Makabe Akio, chief economist at Dai-Ichi Kangyo Research Institute, argued that the recent collapse of the Sogô department store was given as a rationale for the BOJ decision to maintain interest rates as they were. Otake Tomoko, BOJ observer from the Japan Times, posted the following critical question: "If Sogô's collapse can affect monetary policy, what else can?" Another critique of the BOJ decision came from Ueno Yasunari, chief market economist at Fuji Securities Co., who complained that the BOJ had not offered sufficient explanations as to why it decided to leave monetary policy unchanged this time, although it had sent clear signs towards a rate hike (JT, 18 July 2000).

8.6.5 The Termination of the Zero Interest Rate Policy

> " […] it is the role of the central banker to take away the punch bowl, just when the party is getting going." William McChesney Martin, U.S. Federal Reserve Chairman 1951-1970

Finally, on 11 August 2000, the Bank decided to abandon zero interest rate policy and raised the overnight call rate to 0.25 per cent. This was the first rate hike of the newly independent BOJ, and also the first in ten years. Explaining the termination of the zero interest rate policy, Hayami said that zero interest rate policy was promoting moral

[311] Here, one can see the importance of transparency of a central bank. Transparency can be used to inform and prepare the markets of the central bank's monetary policy moves which help to improve the settling of expectations.
[312] Only Policy Board member Shinotsuka voted for a rate hike (Bank of Japan, MPM 17 July 2000).

hazard, which decreases the motivation for Japanese companies, banks and government to restructure, hindering Japan's economic recovery. According to the BOJ, this change in monetary policy was needed due to improvements of the Japanese economy, especially because of a slight increase in corporate profits and fixed business investment (Bank of Japan, Minutes 11 August 2000).[313] Indeed, the Japanese economy did improve and the GDP increased by 3.3 per cent from March 1999 to March 2000 (fiscal year 1999). This was seen as a good chance for the BOJ to lift rates after the quarterly Tankan survey from July showed business confidence was to be better than expected. In April 2000, household spending jumped by 3.6 per cent year-on-year, and the unemployment rate sank to 4.8 per cent from a record 4.9 per cent in March 2000.[314] Regarding the CPI, although there was a positive trend, deflationary trends have been considered as not ended yet. Nakahara (2006: 96-97; 110) argues that the BOJ had prepared for the end of zero interest rate policy since the beginning of 2000. Investigating the results of the Tankan report and other publications, the BOJ took the first chance to put it into practice.

The decision to raise rates was made by majority vote. The Board voted with seven in favour of and two against an interest hike. Only Nakahara Nobuyuki and Ueda Kazuo did not support the rate hike. The reasons for rejecting the chairman's suggestion were made public in the minutes of the Monetary Policy Meeting on 11 August 2000. Both members claimed that the termination of the zero interest rate policy was too early and that it would be better to wait until the economy recovered entirely. Policy Board member Ueda, who had always voted with the majority so far, voted against Hayami's proposal on the following grounds:

> "First, it would be desirable to examine developments in the stock market for a little while longer. Second, the optimal interest rate had at last reached a level around zero, but it would be desirable to wait for the rate to rise clearly above zero. And third, judging from trends in inflation, the cost of waiting would be negligible. He added that his view of the economic situation did not differ significantly from that of other members." (Bank of Japan, MPM 11 August 2000)

Policy Board member Nakahara, who dissented regularly from the chairman's proposal, gave five reasons why he thought that this move was premature:

[313] In an interview with a BOJ official conducted on 24 July 2008 this information was confirmed.
[314] Itô Takatoshi, a critic of the BOJ, admits "[t]o be fair, the economy did look good in the spring of 2000." (Itô 2006: 112).

> "First, a decision to terminate the zero interest rate policy could have a large impact on the Bank's independence and the relationship between the Bank and the Government with respect to the conduct of economic policy. Second, the difference between the views of the Bank's staff and the Government on the economic outlook was especially large in areas such as business fixed investment and exports, and this meant that accountability was insufficient. Third, the decision would further reduce credibility of policy coordination between the Government and the Bank both at home and abroad, and thus it would be desirable to take time out to exchange views and reach a common understanding. Fourth, effectively ending the quantitative easing would not have a positive effect on financial markets, affecting stock prices and the foreign exchange market negatively. And fifth, the justification for raising interest rates when a fairly wide output gap existed could not be explained by orthodox economic theory." (Bank of Japan, MPM 11 August 2000)

Furthermore, Nakahara argued that this decision "would go against the mainstream of thinking in the world of academic economists and could create a view among foreign countries that the Bank was a heretic." (Bank of Japan, MPM 11 August 2000). In sum, the reasons for dissenting by Ueda and Nakahara were different. Ueda's standpoint was close to the majority of the Policy Board, and he simply preferred to wait a little longer (*matsu tachiba*), whereas Nakahara supported a completely different strategy than the rest of the Policy Board with his constant proposal of quantitative easing policy.

8.6.6 The Path to Quantitative Easing Policy

In October 2000, the BOJ published projections of price and economic prospects by Policy Board members for the first time in its history (see, Chapter 6). The projections by the BOJ's Policy Board members ranged from 1.9 to 2.3 per cent growth for the fiscal year 2000, and were more optimistic than the 1.5 per cent estimation made by the government by means of the EPA (JT, 1 November 2000). The minutes of the Monetary Policy Meeting demonstrate that most Policy Board members felt that the termination of the zero interest rate policy was the correct policy. However, since the beginning of 2001, the Japanese economy began to deteriorate again, and the BOJ answered by gradually easing monetary policy. At the Monetary Policy Meeting on 9 February 2001, the BOJ decided to cut the official discount rate (ODR, *kôtei buai*) from 0.5 per cent to 0.35 per cent, which was the first change in the ODR since 1995. In addition, the Bank restarted the outright purchase of short term government securities for the first time in

ten months. The chairman's proposal was not unanimous. Policy Board members Nakahara, Taya and Ueda argued in favour of more radical policy moves. Taya made the following proposal:

> "The Bank of Japan will encourage the uncollateralized overnight call rate to move on average around 0.10 per cent. The Bank of Japan will reduce the official discount rate, with effect from February 13, 2001, by 0.25 percentage point to 0.25 per cent per annum." (Bank of Japan, MPM 9 February 2001)

However, Taya's proposal to cut the key interest rate and the ODR was overpowered by the majority vote with three votes in favour (Taya, Ueda and Nakahara) and six votes against it. Official documents by the BOJ demonstrate that Governor Hayami refused to implement more drastic policy measures, and he was very critical towards the introduction of quantitative easing measures. In a regular press conference on 14 February 2001, he stated that "the effectiveness [of the quantitative easing policy] is unclear and there are many side effects".[315] At that time, Hayami clearly refused to go back to zero interest rates (Bank of Japan, Press conference, 15 February 2001).

Despite the BOJ's easier monetary policy, the Japanese economy showed no signs of improving. At the Monetary Policy Meeting on 28 February 2001, most Policy Board members were concerned about the outlook of the economy, because "the pace of the ongoing economic recovery had been slowing further […] and uncertainty over economic prospects had also increased" (Bank of Japan, MPM 28 February 2001). Therefore, at the Monetary Policy Meeting on 28 February 2001, the BOJ decided to reduce both the overnight call rate target and the official discount rate by 0.1 per cent. The overnight call rate was cut to 0.15 per cent. Both, Nakahara, who suggested a return to zero rates, and Shinotsuka, who preferred to keep the interest rate at 0.25 per cent, opposed the chairman. The ODR was reduced to 0.25 per cent, and again Nakahara and Shinotsuka opposed this decision. In the subsequent press conference, Hayami stressed that the BOJ has to widen its policy measures. This time, Hayami did not exclude a return to zero interest rates and quantitative easing policy measures (Nikkei, 1 March 2001). The BOJ's gloomy assessment of the Japanese economy did not change,[316] and the BOJ started to implement aggressive monetary easing measures in order to stop further price declines.

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[315] In Japanese: "*kôka ga fukakujitsu no ue ni fukusayô mo ôkii*".
[316] The BOJ's view can be seen in the semi annual outlook and risk assessment published in April 2001.

8.6.7 The Quantitative Easing Policy

Finally, on 19 March 2001, the BOJ adopted the so-called quantitative easing policy[317] (QEP) framework[318] in which the main operational target of monetary policy was changed from the overnight call rate to the outstanding balance of the current account (CAB) held by financial institutions at the BOJ.[319] [320] Immediately after the announcement, the Bank increased the current account balance to around five trillion Yen (Table 8-8) from the average outstanding of four trillion Yen in February 2001. Deputy Governor Yamaguchi (2001) emphasized that the raise in the amount of CAB was a policy measure for a limited amount of time:

> "[T]he Bank did not simply raise the target [of CAB] regardless of demand. The Bank decided the level of the target such as five trillion or six trillion based on a judgement that it was the maximum demand for the current account balance at the time."

Similar to the zero interest rate policy, the BOJ committed to provide bank reserves at a level well above the required amount until the actual and expected core CPI inflation turned positive on a sustainable basis.[321] Baba et al. (2006: 106) view the quantitative easing policy "as a version of the zero interest rate policy plus the provision of reserves well in excess of the levels necessary to achieve a zero short-term rate". Kimura et al. (2002: 3) stated that the BOJ had decided "to finally discard the orthodox framework and adopt a new framework". Fukui commented the implementation of the quantitative easing policy as follows:

> […] the economy faced a severe challenge, the potential risk of falling into a vicious cycle, or so-called deflationary spiral, in which a fall in demand reflecting deterioration of the economy causes a decline in prices and this in turn leads to a further fall in demand. To counter this situation, the Bank acted decisively and introduced the quantitative easing policy, which was unprecedented in the history of any central bank, with the aim

[317] It should be noted, that the BOJ already in 1999 discussed the introduction of quantitative easing measures. In the Monetary Policy Meeting on 12 March 1999 Policy Board member Nakahara Nobuyuki proposed to ease monetary policy through a quantitative easing framework. Since then Nakahara continued to propose quantitative easing policy, but most of the time he stood alone with his effort.
[318] Bernanke et al. (2004: 17) interpret the quantitative easing policy as a revival of the zero interest rate policy. However, in comparison to the zero interest rate policy (0.02-0.03 per cent), the overnight call rate was even lower under the quantitative easing policy (0.001-0.002 per cent) (Shimizu 2004: 264-268).
[319] Buiter (2008) defines quantitative easing as "an increase in the *size* of the balance sheet of the central bank through an increase it is monetary liabilities (base money), holding constant the composition of its assets."
[320] For details of the quantitative easing policy framework, see, e.g. Fukui (2003) and Shirakawa (2002).
[321] See, the "New Procedures for Money Market Operations and Monetary Easing", Bank of Japan, 19 March 2001.

> of preventing a continuing fall in prices and establishing a foundation for achieving sustainable economic growth. (Fukui, 16 March 2006: Speech)

Fujiki et al. (2004) argue that the quantitative easing policy was a "political sign" for the future path of monetary policy, since it stands for a high degree of reliability. In more detail, the quantitative easing policy was introduced to intensify the impact of zero interest rate policy, particularly through the commitment effect, meaning that this policy tool is effective until the CPI raises above zero (Bank of Japan 2001; Kanno 2009: 10). In sum, the quantitative easing policy consisted of three pillars:

1. Open-market operations through the outright purchase of government bonds
2. An increase of the current account balances by financial institution at the BOJ
3. A commitment or policy duration effect, which is a commitment to maintain quantitative easing policy until deflationary concerns are dispelled.[322]

However, Baba et al. (2005: 68-71) and Hetzel (2004: 3-4) argue that each of the pillars could be considered separately. The commitment to provide ample funds of liquidity is similar to the commitment of the zero interest rate policy. The purchase of government bonds can be conducted without an increase of the current account balance. However, conversely, an increase of the current account is connected with the purchase of the government bonds (Hamada 2004: 233-237). Indeed, the minutes of the Monetary Policy Board demonstrate that Board members were divided over the effectiveness of quantitative easing policy and some members were worried about potential side effects (Bank of Japan 2001). With the commitment to maintain the quantitative easing policy until deflationary concerns are dispelled, the BOJ hoped to discourage banks from holding excess liquidity (Yamaguchi Hirohide 2004).

Five days after Fukui took the helm of the BOJ on 20 March 2003, he held an ad hoc Monetary Policy Meeting to explain his basic understanding of the current situation. Governor Fukui argued that:

> "it was necessary to discuss contingency measures for the immediate future at a Monetary Policy Meeting. In addition, the Bank should promptly examine the policy framework of monetary easing for the longer term, taking into account downside risks stemming from the

[322] Hamada (2004: 233-237) argues that foreign direct interventions also belong to the concept of quantitative easing policy. However, since the MOF is responsible for these kinds of actions a detailed analysis will not conducted here.

> situation in Iraq, considering the fact that new members had joined the Policy Board." (Bank of Japan, MPM 25 March 2003)

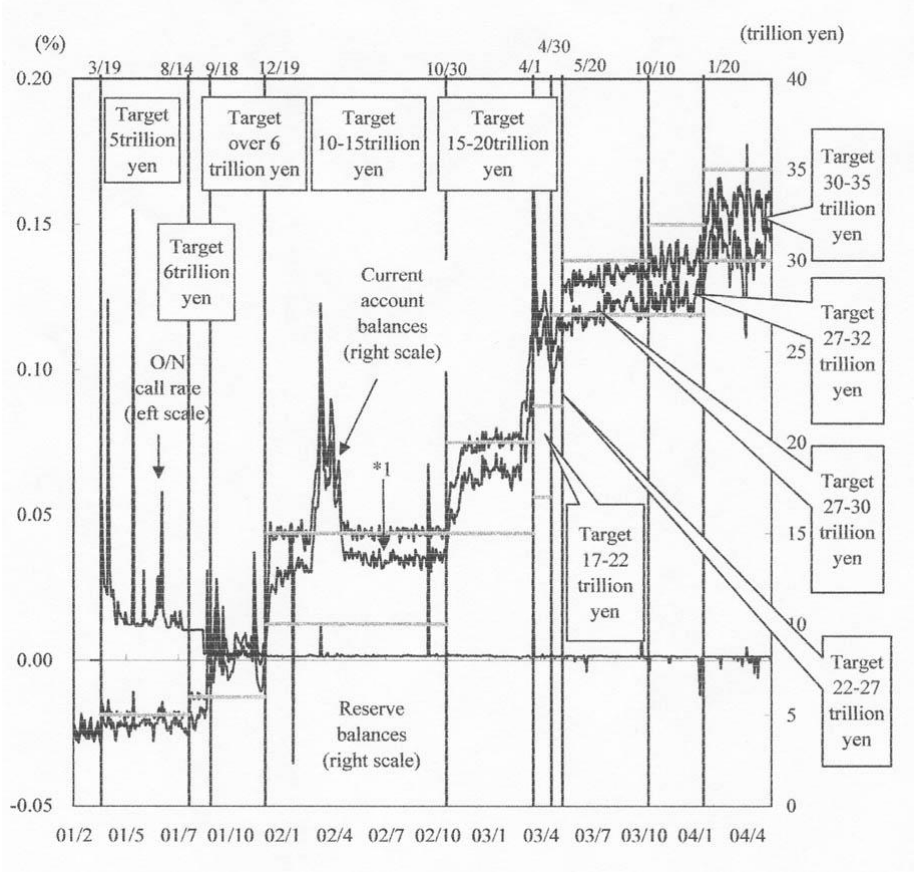
There were certain Board members who were concerned that ad hoc meetings of the Policy Board would harm the transparency of the Bank of Japan. As a consequence, Fukui emphasized that this ad hoc meeting of the Policy Board was a rare exception (Bank of Japan, MPM 25 March 2003). Generally, Governor Fukui was much more enthusiastic about raising the target amount of CAB than his predecessor Hayami. Between April 2003 and January 2004, the CAB was increased from 17 to 22 trillion to 30 to 35 trillion Yen (Table 8-8 and Figure 8-5). In addition, the Fukui-led BOJ introduced some non-traditional monetary policies, including buying stocks, purchases of exchange-traded funds (ETF), real estate investment trust funds (REIT), asset-backed securities (ABS; *shisan tanpô shôken*) and asset-backed commercial paper (ABCP; *shisan tanpô komâsharu pêpâ*) (MPM, 11 June 2003). The advantages of these policy tools are the BOJ's commitment to fight deflation and the BOJ diversification of its portfolio, avoiding excessive holding of JGB's (Hamada 2004: 237-238).

Table 8-8: Development of the Balance of Current Accounts and the Outright Purchase of JGB's

Date	Target balance of current accounts (CAB) (in trillion Yen)	Outright purchase of long-term JGB's (in billion Yen/month)
03/2001	5	400
08/2001	6	600
09/2001	>6	600
12/2001	10-15	800
02/2002	10-15	1000
10/2002	15-20	1200
04/2003	17-22	1200
04/2003	22-27	1200
05/2003	27-30	1200
10/2003	27-32	1200
01/2004	30-35	1200

Source: Kimura and Small 2006: 37.

Figure 8-5: Target Reserve and Actual Balance under the Quantitative Easing Policy



Source: Bank of Japan (2005): Annual review.

8.6.8 The Termination of the Quantitative Easing Policy

In 2005, the Japanese economy showed signs of revival and the termination of quantitative easing policy became a popular issue in the BOJ. Since April 2005, some Policy Board members, mainly Mizuno and Fukuma, had started to suggest decreasing the amount of CAB held at the BOJ. On basis of their views, since the end of 2005, Fukui has begun to announce that the BOJ was looking for an exit out of the quantitative easing policy. For instance, he expressed the following in a speech on 22 December 2005:

> "[T]he possibility of a departure from the unprecedented framework of the quantitative easing policy, which was introduced to stave off a deflationary spiral, is likely to increase over the course of fiscal 2006."

By October 2003, the conditions for an exit of the quantitative easing policy were clarified by the BOJ: "until at least actual core CPI inflation and its forecast by monetary Policy Board members exceed zero" (Baba et al. 2006: 119). In 2005, the BOJ

stated that if the following three conditions were met, the quantitative easing policy would be abolished by the Bank of Japan (Bank of Japan 2005):

1. The year-on-year changes in the core consumer price index must remain stable above zero
2. The Policy Board must be convinced that deflation will not return
3. There are no other economic factors that requires a continuation of loose monetary policy

Finally, on 9 March 2006, the Policy Board decided to end the quantitative easing policy and implemented a new monetary policy framework (*arata na kinyû seisaku unei no wakugumi no dônyû ni tsuite*). The BOJ's new framework of monetary policy was based on two pillars: First, an assessment of expected developments in economic growth and inflation over a one-to-two-year horizon. Whether the result of the BOJ's semiannually published "Outlook and Risk Assessment" coincides with the BOJ's Policy Board's understanding of price stability is of particular interest. The agreement of medium- to long-term price stability of Policy Board members ranges from 0 to 2 per cent with a median value of 1 per cent.[323] The second pillar was meant to cover the risks which threaten sustainable growth and price stability over a longer time period and which might require a higher extent of flexibility in the conduct of monetary policy (Assenmacher-Wesche, Gerlach and Sekine 2008: 346-348; Iwata 2008). It was argued that the new policy framework of the BOJ provided a clearer understanding of the central bank's targets and that transparency was enhanced. Regarding the transparency of the new policy framework, Iwata (2008) remarks that "we [the Policy Board] make policy decisions by examining the plausibility of our scenario presented in the semi-annual outlook and by assessing the various risks and the uncertainty ahead for our economy". In other words, the new policy can be explained as "forecast-based policy". The BOJ has implemented an approach in which each individual Policy Board member estimates the suitable course of future policy interest rates by providing forecasts of real GDP, core CPI and CGPI over a two-year time horizon, "thereby taking into account market expectations on the future development of policy rates" (Iwata 2008). With the new monetary policy framework, the main operating target changed from CAB to the

[323] However, this framework differs from the "ECB's numerical definition of price stability over the medium term (below 2%, but close to it)." The target of the BOJ is determined by the Board members. In other words, if Policy Board member change, the monetary policy stance can also change, and so "it is possible to revise the numerical target regularly" (Iwata 2008).

overnight call rate. Soon after the termination of the zero interest rate policy, the BOJ started to work towards interest rate hikes. On 13 July 2006, the BOJ raised interest rates to 0.25 per cent. In the press conference after the Monetary Policy Meeting, Governor Fukui stated that the BOJ did not intend to realize any further interest rate hikes (Nikkei, 16 July 2006). However, in February of 2007, there was a second rate hike to 0.5 per cent. This decision was made by majority vote, however, Deputy Governor Iwata voted against the chairman's proposal. This was the first time in the BOJ's history that a Deputy Governor opposed the Governor. The following sections focus on pressure exerted on the Bank of Japan by the government and politicians regarding monetary policy decisions.

8.7 Pressure on the Bank of Japan by the Government and Politicians

8.7.1 Introduction

Since the beginning of Hayami's tenure as the first Governor of the new BOJ, a scheme of permanent conflicts between the government and the central bank has arisen (Arita 2007: 16). Dwyer (2007) suggests that Japanese lawmakers faced strong "incentives to become even more proactive participants in monetary and financial market policy debates than ever before." She even goes as far as to say that "in large part this politicisation was intentionally encouraged by the law itself." Dwyer's argumentation strengthens this thesis' findings from Chapter 3 and 4, namely that Japanese politicians never intended to make the BOJ independent in a de facto sense.

When taking into account that an independent central bank is viewed as the international standard, it is surprising that the Japanese government pressured the BOJ right after the new BJL came into effect in April 1998. Indeed, the Japanese government tried to hide the pressure it exerted on the Bank in the Monetary Policy Meetings. As demonstrated in Chapter 6, the Bank of Japan Law requires the publication of complete transcripts of Monetary Policy Meetings (BJL, Article 20, Paragraph 2). The transcripts confirm that the government already exerted pressure on the new BOJ in the first meeting on 9 April 1998. That is, it is apparent that the government did not recognize that it was no longer in the position to administer orders to the BOJ in a de iure sense. However, in the 9 April 1998 Monetary Policy Meeting, the then-Director General of the EPA Omi Kôji requested a more pessimistic view from the BOJ in regards of the Japanese economy. The transcripts revealed that Omi pressured the Bank to refrain from

publishing statements that hindered the government's stimulus measures (Bank of Japan, MPM 9 April 1998). However, the BOJ refused to alter its standpoint on the economy and continued to maintain a pessimistic stance concerning future prospects of the Japanese economy. Afterwards, the EPA requested the Bank omit Omi's statements from the summary of the minutes released on 22 May 1998 (JT, 1 August 2008). This demonstrates that the EPA was well aware that disproportional pressure on the BOJ could harm the credibility of the government and the BOJ.

Another example of political pressure soon after the new BOJ Law took effect in April 1998 occurred in July 1998. A group of LDP politicians believed that the BOJ acted too passively when it came to the deflation problem in the Japanese economy, and stated harsh critique of the central bank. A political explanation for the attacks on the BOJ might be that LDP lawmakers were concerned about the Upper House election on 12 July 1998 as survey results were unfavourable for the Hashimoto Cabinet. Indeed, the LDP lost the majority in the Upper House and Prime Minister Hashimoto stepped down, taking responsibility for the defeat. Obuchi Keizô was elected to the new Prime Minister.

One key question is whether or not political pressure influenced monetary policy decisions by the BOJ. Arita (2007: 19) argued that the government and MOF bureaucrats sharply influenced lawmakers, in particular on the subject of monetary easing. For instance, Policy Board member Shinotsuka believed that the reason the interest rate was cut in September 1998 was intense political pressure (Fujii 2004: 85). The following sections provide an analysis of political pressure on the Bank of Japan and its main monetary policy decisions, including the zero interest rate policy between 1999 and 2000 and quantitative easing policy between 2001 and 2006.

8.7.2 Political Pressure and the Zero Interest Rate Policy

8.7.2.1 Political Pressure during the Zero Interest Rate Policy

In February 1999, the government continued to exert intense pressure on the BOJ. For instance, Chief Cabinet Secretary Nonaka Hiromu and Ikeda Yukihiko, Head of the LDP's Policy Research Council, publicly called on the BOJ to do more against the rise of long-term interest rates. At a press conference on 8 February 1999, Nonaka argued that the BOJ is responsible for the dull development and prospects of the Japanese

economy. In order to overcome the deflationary problems of the Japanese economy, the BOJ should employ stronger monetary policy measures. Nonaka urged the BOJ to purchase circulating Japanese government bonds in the market (Arita 2007: 18; Asahi, 12 August 2000; Fujii 2004: 107-108). However, Arita (2007: 18) argues that the statement by Nonaka was just 'tatemae', what Nonaka really wanted was for the BOJ to underwrite the government's newly issued JGB, which the BOJ constantly refused to do. The issue of buying government bonds was a subject of fierce disputes between the government and the BOJ. In the Bank of Japan there was a broad consensus that the underwriting of government bonds would undermine the central bank's independence.[324] Concerning the underwriting of JGB, the BOJ's Policy Board was very critical, and members pointed out the risks, for example, in regards of fiscal deficit. For instance, the minutes of the Monetary Policy Meeting of 19 January 1999 state that:

> "one member pointed out that there were good reasons for this [the underwriting of JGB] being prohibited by the Public Finance Law. The member expressed clear objection to such activity, claiming that it would undermine the credibility of the central bank and lead to the loss of fiscal discipline. This view was shared by the Board members." […] Regarding JGB outright purchasing operations, many members argued against expanding such operations to influence long-term interest rates. Many members claimed unequivocally that, if the Bank actively purchased JGBs, market participants would interpret this as the monetization of the fiscal deficit." (Bank of Japan 1999, Minutes of the MPM, 19 January 1999).

Another example is Okina Kunio, then-economist at the IMES, the research department of the BOJ. He argued fiercely against the BOJ underwriting JGB. Okina compared this policy measure with the experience of hyperinflation in the Weimar Republic:

> "The absorption of government bonds by the BOJ would be akin to introducing a (illegal) drug into the economy. [I]f the government came to accept such indulgence there is a very real risk that it would be difficult to end […], because it would be too painful, as is evidenced by historical experience, and might impair the national interest of Japan from a long-term perspective. In this context, it is noteworthy that there are some who, in the view of recent accumulation of fiscal deficit, predict that Japan might follow the same path as the Weimar Republic, whose massive budget deficit was monetized by the central bank's underwriting of government bonds, only resulting in economic crisis with hyperinflation, capital flight and a GDP decline" (Okina 2007).

[324] See, Bank of Japan, various issues of minutes of Monetary Policy Meetings.

The introduction of the zero interest rate policy in February 1999 was decided after a tough fight with the government and MOF. It can be hardly seen as coincidence that on the very Monetary Policy Meeting on 9 February 1999, Sakaiya Taichi, Minister of State for Economic Planning, joined the Monetary Policy Meeting (see, Appendix D). Shinotsuka reports that this meeting was characterised by a high extent of governmental pressure, and that many Policy Board members were extremely nervous. This Monetary Policy Meeting lasted almost eight hours, much longer than usual. A "system of driving the BOJ into a corner" (*nichigin wo oikomu taisei*) had started (Fujii 2004: 104-115).

Fujii (2004: 110-111) argues that the BOJ's basic standpoint of the Japanese economy, which is published, e.g., in the Monthly Report, did not change significantly between January and February of 1999. If this is true the assumptions of intense government pressure would be confirmed, resulting in the introduction of the zero interest rate policy. Governor Hayami was challenged by numerous questions regarding governmental and political pressure on the BOJ in the subsequent press conference of the Monetary Policy Meeting. Hayami patiently denied the existence of intense pressure coming from politicians, arguing that the BOJ decided monetary policy in accordance with its own beliefs (Bank of Japan 1999, Press conference, 12 February 1999). However, many sources demonstrate that the BOJ, including Governor Hayami, was highly concerned about zero interest rate policy and possible side effects. For instance, the Nikkei Shinbun (1 July 1999) reports that the introduction of the zero interest rate policy was regretted by the inner circle of the BOJ. Many BOJ officials regarded the introduction of the zero interest rate policy as a lost fight against the government that could result in a weakening of the BOJ's independence in the long-run (Arita 2007). On 30 June 1999, Hayami said to Suzuki Yoshio, member of the Liberal Party and former BOJ executive that "zero interest rates are an abnormal condition." This and other statements encouraged speculation that the BOJ sought to terminate the zero interest rate policy as soon as possible. In September of 1999, the BOJ's Policy Board decided monetary policy would remain unchanged, although there was intense pressure from politicians. Markets had expected a policy change which would proceed in the direction of a further easing of monetary policy in order to fight against the strong Yen. However, the BOJ left monetary policy unchanged at the Monetary Policy Meeting on the 22 September, resisting pressures from the Japanese government and outside pressure from the US government. This decision was a shock to the market. The Japan Times (22

September 1999) commented that the BOJ's decision "lurks a central bank struggling for independence", building the impression that political reasons played a main role for this decision. In this case, the BOJ was successful in resisting governmental pressure.

However, the BOJ was not always able to resist pressure from the government and politicians. For example, after Mori Yoshirô became new Prime Minister in April 2000, and right before the Lower House election on 25 June 2000, political pressure on the BOJ increased to a high extent. Prime Minister Mori had only little support in the public and feared that a rate hike would weaken the Japanese economy and, thus, worsen the LDP's chances for the upcoming election.[325] Facing a possible defeat in the election, Mori constantly repeated his claim that the BOJ should maintain the zero interest rate policy. First, this claim was rebuffed by Hayami in a press conference on 14 June 2000, in which the Governor emphasized the necessity of an almost immediate termination of the zero interest rate policy (Bank of Japan, press conference, 15 June 2000). However, in reality, the BOJ was reluctant. The BOJ intended to raise rates, but, suddenly refrained from doing so. The reason for the hesitant behaviour of the BOJ was probably that the government and LDP politicians, such as Kamei, Chairman of Policy Research Council, Aizawa, Chairman of the Financial Reconstruction Commission, and, most importantly, Prime Minister Mori put pressure on the BOJ to not raise interest rates. Nakahara (2006: 123) reports that on 14 July, Prime Minister Mori, Finance Minister Miyazawa and Sakaiya Taichi, Director General of the EPA, consulted and concluded that there was no other choice than to make use of the government's right to request a postponement of a monetary policy decision if the Bank should decide to terminate the zero interest rate policy. Mori confidently stated on 14 July that he did not expect a policy change from the BOJ in the upcoming Monetary Policy Meeting on 17 July (Asahi, 15 July 2000). Indeed, the BOJ left monetary policy unchanged (see, Bank of Japan, Minutes), and many observers (e.g., Otake 2000) argued that the collapse of the Sogô department store chain was used as a reason for the BOJ's decision. Yet, it is hard to believe that the collapse of the Sogô alone had enough influence to trigger financial panic, and change the intentions of the BOJ.[326] It is possible, however, to argue that the

[325] In the end, the ruling coalition of LDP, Liberal Party, and Kômeitô maintained its majority in the Lower House election on 25 June 2000, although the ruling coalition lost seats and power.
[326] According to some observers, it was inordinately to postpone a rate hike just because of Sogô's failure (e.g., Otake 2000).

Sogô problem (*sogô mondai*) was just used as an excuse for the BOJ to not raise interest rates at that time, and that the true reason was the intense political pressure.

8.7.2.2 Political Pressure during the Termination of the Zero Interest Rate Policy

Political pressure on the BOJ continued, and Prime Minister Mori repeated that the bad condition of the Japanese economy required maintaining the zero interest rate policy for some time. On 9 August 2000, LDP politicians even threatened to revise the BOJ Law, in particular in regards of firing the Governor (Yomiuri, 12 August 2000). This was a direct threat towards Hayami should the Bank decide to terminate the zero interest rate policy. Before the Monetary Policy Meeting on 11 August 2000, many lawmakers from the ruling party, including Prime Minister Mori, Finance Minister Miyazawa, Kamei Shizuka (Chairman of the LDP policy research council), Aizawa Hideyuki (chairman of the Financial Reconstruction Commission), Sakaiya Taichi, and Hiranuma Takeo (International Trade and Industry Minister), criticised the BOJ, claiming that a termination of the zero interest rate policy would be realized too early. Miyazawa tried to split the Policy Board of the BOJ, and stated that Governor Hayami was isolated in the opinion that the BOJ should abandon the zero interest rate policy and raise interest rates (Nakahara 2006: 121-122). Critics claimed that Hayami's view was a "special theory" (*tokuron*) and did not represent the common opinion of the BOJ. For instance, Hayami regarded deflation as not particularly troublesome, and believed that zero interest rates might hurt households' interest income (Yoshitomi 2006: 137).

However, the minutes of the BOJ's Monetary Policy Meeting proved that Miyazaki's argument that Hayami was alone in favouring and deciding to end the zero interest rate policy was wrong. Indeed, the opinion regarding the termination of the zero interest rate policy was split within the BOJ. Yamawaki (2002: 271) cited BOJ officials who believed that the abandonment of the zero interest rate policy was a mistake and that the quantitative easing measures should have been implemented earlier. Contrarily, the majority of the Policy Board voted in favour of a termination of the zero interest rate policy on the basis of a judgement that the Japanese economy showed signs of recovering. Only Policy Board members Nakahara and Ueda voted against the chairman's proposal. This shows that Hayami's opinion was not isolated in the BOJ.

The government and the vast majority of the LDP exerted strong pressure (*kajô na kainyû*) against an interest rate hike, and mobilised as much confrontation as possible. In the LDP, only Horiuchi Ko was in favour ending the zero interest rate policy (Nakahara 2006: 121-122). However, the BOJ resisted all pressure from politicians successfully. It can be argued that the termination of the zero interest rate policy was an unprecedented case in which the BOJ disregarded intense opposition and specific government demands (Yamawaki 2002: 266). The rationale behind the confrontation was a different assessment of the Japanese economy. The different views regarding the condition of the Japanese economy between the BOJ and the government were clearly demonstrated in the BOJ's Monthly Report (*kinyû keizai geppô*) and the government's Monthly Economic Report (*getsurei keizai hôkoku*). The BOJ was optimistic (*tsuyoki*) in regards of future prospects of the Japanese economy, the government, however, continued to maintain a cautious stance (*shinchô*). As a consequence, both reports revealed substantial differences regarding the future development of macroeconomic fundamentals such as consumption, employment, income, and public investment.

The government's position was supported by prominent representatives of the Japanese industry, for instance, Imai Takashi, chairman of the Keidanren, Okuda Hiroshi, chairman of the Nikkeiren, Inaba Kosaku, chairman of the JCCI (Asahi and JT, 12 August 2000), and members from the Industrial Bank of Japan (IBJ, *Nippon Kôgyô Ginkô*). All argued against the termination of the zero interest rate policy. Fujiki and Shiratsuka (2002) declare that the BOJ's explanation after the Policy Meeting on 17 July 2000 seemed to have misled market participants into believing that the zero interest rate policy would not be terminated for a considerable amount of time. Therefore, the Bank's decision on 11 August came as a surprise for some actors, and was consequently criticised by private-sector economists. In contrast, some support, or at least understanding for the BOJ came from some businessmen, e.g., Ushio Jirô, President of Ushio Electronics, and Kobayashi Yôtarô, President of Fuji Xerox (Satô Yamato, Nikkei, 9 August 2000). Senior strategist of the Daiwa Institute of Research Ltd., Nakano Mitsuhiro, argued that the market and the business sector were well prepared for an interest rate hike, and the markets responded in accordance with the BOJ's calculations (JT 12 August 2000).

Although most economists and business leaders criticised the decision to end the zero interest rate policy as premature, economists regarded a raise of the interest rates by 25 basis points as not strong enough to hinder the recovery of the Japanese economy. In general, the economic impact of miniscule rises in interest rates leaves room for discussion. According to Blinder et al. (2001: 62), a "change of 0.25% has relatively little effect […] on either output or inflation." Itô (2006: 115) confirms this view that a raise in interest rate has little impact on investment or consumption. Based on these arguments and to counter critics, Hayami and other Policy Board members argued that the decision to end the zero interest rate policy was just a "small adjustment" to monetary easing, and that the BOJ would continue easy monetary conditions to support economic recovery (Bank of Japan, MPM 11 August 2000; Hayami 2000: Speech at Keizai Club, 22 December 2000). Indeed, in an economic sense, the end of the zero interest rate policy was just a small step, politically, however, it set a new milestone in the relationship between the central bank and the government.

8.7.2.3 The Monetary Policy Meeting on 11 August 2000

The transcripts of the minutes of the Monetary Policy Meeting on 11 August 2000 demonstrate that the government did exercise its right to request a postponement of the monetary policy decision (Article 19, Paragraph 2). Yet, the request was denied by the Policy Board (Article 19, Paragraph 3). This was the first time that the government requested a postponement of the Policy Board's decision. The participating government representatives were Murata Yoshitaka, Senior State Secretary for Finance, Ministry of Finance and Kawade Eiji, Director General of the Coordination Bureau, EPA. According to the BOJ Law, Article 20, Paragraph 2, the BOJ has to publish the complete transcripts (*gijiroku*) of the Monetary Policy Meeting „after an appropriate amount of time" (*sôtô kikan keika go*). In practice, the BOJ decided to publish the *gijiroku* after ten years (see, Chapter 6). The transcripts of the Monetary Policy Meeting held on 11 August 2000 revealed interesting details about the process of terminating the zero interest rate policy. Hayami, who was irritated by former statements made by Kamei, started a dispute with government representative Murata. In order to proceed with the agenda, Policy Board member Shinotsuka had to interrupt the dispute (pp. 76-77). Policy Board member Nakahara Nobuyuki, who agreed with government's demands to maintain the zero interest rate policy, criticised some of his colleagues, in particular Deputy Fujiwara, for not having an own opinion. He accused them of

preferring to follow Governor Hayami and the majority of the Policy Board (pp. 79-80). This is known as a typical free-rider problem. Murata repeated the position of the government in a statement,[327] agreeing that a rate hike at this very moment would have been premature. However, after the majority of Policy Board members argued in favour of the termination of the zero interest rate policy, Murata informed Finance Minister Miyazawa and Kawade contacted Sakaiya, Minister of State for Economic Planning, about the BOJ's intention. Both Ministers instructed Murata and Kawade to make use of Article 19, Paragraph 2, and to request a postponement of the decision.

After the government representatives Kawade and Murata expressed their opinions concerning the economic condition, Hayami asked if they wished to exercise the government's right to request a postponement of a decision (p. 89), which Kawade and Murata affirmed after consulting with their Ministries. Policy Board member Miki asked the government representatives to state the reason behind their request in more detail (pp. 96-97). Governor Hayami shortened the discussion by requesting the vote over the government's request. The Policy Board voted eight in favour of and one against rejecting the government's request. Unsurprisingly, only Nakahara voted in favour of the government's request (pp. 107-108). After the Policy Board voted down the request of the government, the Policy Board voted over monetary policy, and decided to terminate the zero interest rate policy by majority vote.

However, the employment of Article 19, Paragraph 2 was not a spontaneous decision by the government. The procedure of the Monetary Policy Meeting indicated that the government was not surprised by the BOJ's decision, and planned to make use of its right to request a postponement of a monetary policy decision in advance. On 8 August, Hayami attended a meeting of Cabinet members (getsurei keizai hôkoku kankei kakuryô kaigi) and explained that the majority of Policy Board members were in favour of terminating zero interest rates. Almost immediately, government members such as Prime Minister Mori, Kamei, Sakaiya and Hiranuma stated their fierce opposition. The following day, LDP Diet members, including Yamamoto and Watanabe joined in protesting against the BOJ's plan. Nakahara (2006: 126) argues that two days before the Monetary Policy Meeting, the government had already decided to make use of its right

[327] In every Monetary Policy Meeting both government representatives present in statements the government's view regarding the economy and monetary policy.

to request a postponement of a monetary policy decision should the Policy Board really decide to terminate the zero interest rate policy. However, how exactly Article 19 should be employed was unclear to Policy Board members and the government representatives. Consequently, Policy Board members actively discussed the correct application of Article 19, Paragraph 2 in the Monetary Policy Meeting, because this is not clearly settled in the BJL. The "Report concerning the Revision of the Bank of Japan Law" by the FSRC, which was submitted to the Finance Minister on 6 February 1997, states that:

> "It is important to give the Government an opportunity to fully explain its views at monetary policy meetings in order to ensure consistency between the policies of the Bank and the Government and secure transparency in the decision-making process. Therefore, since the framework provides a means to coordinate the differing views of the Government and the Bank on monetary policy, the Policy Board should make sure that the Government fully explain its views before taking a vote."

Mutô Toshiro from the MOF pointed out that the application of Article 19 is very unclear. Mutô acted as Deputy Vice Minister for Policy Coordination at the Ministry of Finance during the BJL reform process, and stated at a Diet session on 14 May 1997:

> "When a proposal put forward at a monetary policy meeting is broadly in line with what the Government had been expecting and the Government's position on that proposal has been almost decided, the Government representatives can immediately explain their views and the Board make a judgment [...] However, there might be cases where the Government's stance on a new proposal has not yet been decided. In such cases, the Government would need a certain amount of time, not too long, to examine the proposal and decide its stance. There also may be cases where Government representatives, in response to a question from a Policy Board member, might not be fully prepared to explain the Government's views. I am afraid I cannot yet give a clear answer on what sort of cases the Article [19] could apply to, but, the situations I have just mentioned, although somewhat unspecific, may give some idea of the circumstances under which the Government can request that a vote be postponed." (Bank of Japan, MPM 11 August 2000).

In sum, the right of postponement of a monetary policy decision was debated intensely in the Monetary Policy Meeting, and it was unclear to the Bank of Japan how to use this article until it was to be employed the first time in practice. Anyway, the Policy Board voted down the government's request and terminated the zero interest rate policy despite the demand of the government. This decision was a political signal to the

government that the BOJ was willing and even strong enough to resist political pressure and could act independently.

8.7.2.4 Political Implications of the Termination of the Zero Interest Rate Policy

Regarding the termination of the zero interest rate policy, many observers (e.g., Fujii 2004; Lukauskas and Shimabukuro 2006; Posen 2000; Lincoln 2001; Nakahara 2006: 130-131) argue that the BOJ's (in particular Hayami) primary aim was to demonstrate independence. Based on the experience of being dependent on the MOF and government for a long time, the BOJ willingly took the chance to demonstrate its independence. The BOJ made sure that it "would neither easily accommodate the Ministry of Finance's requests nor accept MOF leadership in the coordination of macro-economic policy" (Bertoldi 2003: 11). It can be argued that the fierce opposition of the government (e.g., from Prime Minister Mori, Finance Minister Miyazawa, and Kamei) convinced Hayami and the BOJ even more that simply following the government's course of economic policy could be political costly in the future, and result in a reduction of the BOJ's independence. In this case, the Bank's primary motive was politically motivated, and not necessarily focussed on the economic conditions (Lincoln 2001). However, the assessment of the economy by the BOJ hinted that a recovery took place and that the termination of the zero interest rate policy was economically justified. A justification that proved to be wrong one year later, and the BOJ had to adjust its monetary policy.

In the press conference after the Monetary Policy Meeting on 11 August 2000, Hayami stressed the independence of the BOJ and that the final decision of monetary policy is in the hands of the BOJ. Hayami confidently stated that "it is our [the Bank of Japan's] duty to demonstrate independence. We [the BOJ] must decide over monetary policy"[328] (Bank of Japan, press conference 12 August 2000). One can argue that the BOJ's decision to end the zero interest rate policy absorbing overt political pressure marks a key point in the BOJ history. With this decision, the central bank proved that it could act independent from the government and politicians.

[328] In Japanese: "*wareware ga kimete ikaneba naranai*"

The government and politicians from the ruling LDP have repeatedly argued that a termination of the zero interest rate policy would be premature. In the press, this claim was called "*jiki shôsô*" or "*shôsô ron*". The government representatives from the MOF and EPA used this argumentation in the Monetary Policy Meetings to make their standpoint clear to the Bank of Japan. Lukauskas and Shimabukuro (2006: 142) observed that many politicians and economists considered the decision to end the zero interest rate policy as an affront against the government in order to gain credibility. In the end, the dispute between the Bank of Japan with politicians can be described as a political show. The termination of the zero interest rate policy triggered harsh criticism not only from the government and the Ministry of Finance, but also by the Economic Planning Agency (EPA), Ministry of Economy, Trade and Industry (METI, *Keizai Sangyô Shô*), Financial Reconstruction Commission (FRC, *kinyû saisei iinkai*) and the Financial Services Agency (FSA, *Kinyû Chô*) (Kobayashi, Spiegel, and Yamori 2006; Nakahara 2006: 127). After the BOJ's made this decision, the relationship between the BOJ and the government became very poor (Harui 2012).

In contrast, it can be argued that the pressure exerted on the BOJ by the government and ruling party lawmakers was too strong, and that politicians' reactions were out of proportion.[329] One reasonable explanation for the heavy amount of pressure exercised on the BOJ from the government and LDP politicians is that politicians were attempting to strengthen their position as leaders (principal) by controlling the BOJ and playing a more important part in policy planning. Referring to Chapter 6 of this thesis, the BOJ used enhanced transparency to explain its policy move to abandon the zero interest rate policy. In numerous speeches, press conferences and interviews, BOJ board members explained their monetary policy stance, and tried to prepare the market towards a change in monetary policy well in advance. Minutes of Monetary Policy Meeting showed that the views of the most Policy Board members became increasingly optimistic in regards of the condition of the Japanese economy. In publications, such as the *Tankan*, the BOJ demonstrated its view that the economy was recovering and that macroeconomic data was improving, which sufficiently justifies an interest rate hike.

[329] Interview with a former MOF official, 2008.

It can be deduced that the BOJ's "wait and see" tactic - the BOJ refrained from raising interest rates immediately – contributed to causing the government and politicians to feel the need to exert exceeding amounts of pressure. In essence, both parties more than likely believed that enough pressure would make the BOJ to follow the government. Another possible interpretation is that government's pressure was provoked by remarks of BOJ staff, in particular Governor Hayami. Hayami claimed in an appearance before the Diet that the economy had reached a stage in which a rate hike is an appropriate policy measure because risks of deflation were gone. In an Upper House committee Hayami admitted that the outlook of the economy was more optimistic within the BOJ than in the government (Japan Times, 10 August 2000).

In conclusion, the termination of the zero interest rate policy brought the BOJ into heavy conflict with the government, Prime Minister Mori, and Diet politicians. With the termination of the zero interest rate policy the BOJ snubbed the Mori government. The government put intense pressure on Governor Hayami, so-called "Hayami bashing" (*Hayami basshingu*) (Nakahara 2006: 88). There were concerns that interventions from the politicians (*seiji kainyû*) in the BOJ were so harsh that long-term harm may result. The markets may begin to distrust whether the central bank can act independently (Nikkei, 12 August 2000). Important for the independence of the BOJ was that the Bank prevailed against all critiques, and resisted political pressure successfully most of the time. Under the old BOJ Law, a rate hike would most unlikely face heavy political pressure from the government. As many case studies show, it was almost impossible for the BOJ to raise rates if the government, e.g., via the MOF, and Diet politicians, acted together against the BOJ.

8.7.2.5 Political Pressure after the Zero Interest Rate Policy

Soon after the termination of the zero interest rate policy, the government and the ruling LDP continued to exert pressure on the BOJ. In November of 2000, facing the IT bubble, Aizawa and Kamei repeated their critique of the BOJ. On 1 December, the Director General of EPA Sakaiya again stated that the termination of the zero interest rate policy was implemented too early, and requested the BOJ to ease monetary policy

to support the economy (Nikkei, 2 December 2000).[330] In contrast to Sakaiya and other LDP politicians who demanded a return to the zero interest rate policy, Vice Finance Minister Mutô Toshirô[331] stated that there is no need for the BOJ to restore the zero interest rate policy, because it could harm the central bank's credibility (JT, 8 December 2000).

For the Bank of Japan, the government's counterpart for institutionalised, high-level cooperation is the Council on Economic and Fiscal Policy (CEFP**,** *Keizai Zaisei Shimon Kaigi*), which is a part of the Cabinet Office. In January 2001, the government established the CEFP with the aim to strengthen the Prime Minister's leadership in policy making. The Council is a forum which supports the Prime Minister through research, analysis and the exchange of information in the field of economic policies. The Council is composed of senior ministers including the Prime Minister and Finance Minister, BOJ Governor, and representatives of academia and business. The Governor of the Bank of Japan is appointed by the Prime Minister to the Council under the 'Law to Establish the Cabinet Office' (Hosen 2007; Mulgan 2013). The fact that the BOJ Governor is a member of this council led to some critique, because this can make the BOJ a target for policy pressure.[332] In a meeting on 2 February 2001, Asô Tarô, Minister for Economic and Fiscal Policy, pressured Governor Hayami to ease monetary policy. Hayami's viewpoint was quite different in comparison to the other members of the CEFP. Hamada Kôichi, President of the Cabinet's Office's Economic and Social Research Institute (ESRI, *Keizei shakai sôgô kenkyû jo*), proposed quantitative monetary easing. Hamada's viewpoint was supported by prominent economists, such as Yoshikawa Hiroshi, Professor at Tôkyô University and Homma Masaaki, Ôsaka University (JT, 3 February 2001; Fujii 2004: 195-196; Nakahara 2006: 156-157).[333]

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[330] It should be noted that Sakaiya's statements were contradictory. In October 2000, he stated that the evaluation of the Japanese economy by the government and the BOJ have become very similar (JT, 1 Nov 2000).

[331] In 2003, Mutô was appointed Deputy Governor of the BOJ.

[332] For instance, the Central Bank Governance Group of the BIS (2009: 149) argues that "some accountability measures could potentially impinge on the independence of the central bank. Regular meetings between the Central Bank Governor and the minister of finance may serve accountability but could also be used to exert political pressures [on the central bank]."

[333] At this point, it has to be noted that not all politicians argued in favour of quantitative easing policy. Nakahara (2006: 110) reports that for instance, influential LDP lawmaker Katô Kôichi was against quantitative easing policy.

Consequently, LDP policy chief Kamei increased the pressure on the BOJ to adopt quantitative easing measures. In a speech at the Foreign Correspondence Club of Japan in Tôkyô on 19 February 2001, he argued that the termination of the zero interest rate policy was a mistake that hindered the Japanese economy from recovering. Kamei demanded a return to the zero interest rate policy and further quantitative easing of monetary policy (JT, 20 February 2001). The monetary policy decision of the BOJ in February 2001 was too small for Kamei. Kamei criticised the decision of the BOJ as "fooling policy" (*me kuramashi saku*), because it fools the public into believing the BOJ is doing something against deflation. He argued that this monetary policy decision had no positive effect on the economy (Nakahara 2006: 160). On 1 March 2001, the ESRI organized an Economic Policy Forum [334] (*Keizai seisaku fôramu*) titled "The Effectiveness and Possibility of Further Monetary Relaxation" (*Kinyû seisaku no kadai – sara naru kinyû kanwa wo megutte*). Some members of the panel, such as Hamada Kôichi and Iwata Kikuo, Professor of Economics at Gakushûin University, demanded further monetary easing by the BOJ (ESRI: 2001; Asahi, 2 March 2001).

Direct pressure came also from the government and the MOF. At a press conference on 26 February 2002, Minister of Finance Shiokawa Masajuro requested the BOJ to increase the buying operations of JGB from 800 billion Yen to 1 trillion Yen per month. It is a rare for a Minister of Finance to criticise and speak publicly about concrete demands regarding monetary policy recommendations. Taniguchi Takayoshi, Vice Minister of Finance, participated in various Monetary Policy Meetings as a representative of the government, and put the claim of Finance Minister Shiokawa into practice by directly requesting the Bank to widen its buying operations of JGB's. Taniguchi's request, which was expressed in Monetary Policy Meetings, persisted continuously from December 2002 to March 2003. This is clear evidence of the MOF's determination to accomplish easier monetary policy.

8.7.3 Political Pressure and the Quantitative Easing Policy

8.7.3.1 Political Pressure during the Quantitative Easing Policy

It can be argued that the introduction of the quantitative easing policy in March 2001 was a personal defeat for Governor Hayami, because it was a sign that the ending of the

[334] The Economic Policy Forum is organized as an open-panel discussion by scholars and experts in- and outside the government.

zero interest rate policy in August 2000 was a policy mistake. Facing a severe economic downturn and harsh political pressure, the BOJ could not simply return to zero rates, because this would be an admission that the termination of the zero interest rate policy in August was in fact a policy mistake. Hayami had to introduce a new monetary policy framework to keep his countenance. The introduction of the quantitative easing policy was the BOJ's most difficult decision (*mottomo muzukashii handan*). One day before the Monetary Policy Meeting on 19 March 2001, the government made a clear statement that they expected a change in the monetary policy stance of the BOJ owing to the worsening economy (Nakahara 2006: 167). The BOJ had no other choice, but to follow the government's demand.

Lukauskas and Shimabukuro (2006: 143-144) interpreted the introduction of quantitative easing policy as an indicator that the BOJ had changed its mind towards building a closer cooperation with the government. However, this conclusion is not totally convincing. It is rather that the BOJ connected the decision to introduce quantitative easing with the request to the government to conduct structural reform (Fujii 2004: 234-236; 245). The BOJ stated that after they had implemented quantitative easing policy, it would be the turn of the government (*seifu ni baton tacchi*) to promote structural reforms in order to revive the Japanese economy (Hayami 2001, press conference on 19 June 2001; Yamaguchi 2001, press conference on 5 July 2001). Members of the Policy Board continuously emphasized that structural reforms made by the government were essential to overcome deflation pressures. The minutes of the Monetary Policy Meeting on 14-15 June 2001 declare:

> "One [Policy Board] member said that it should be noted that the scope for further monetary policy measures was limited. Another member commented that the economy could not be stimulated by monetary policy alone, and thus it was important to implement structural reforms."

This quote makes it clear that some members of the Policy Board believed that monetary policy alone was insufficient to boost the economy. Rather, the government must intensify their efforts and introduce structural reforms. One important feature of quantitative easing policy was an increasing amount of buying operations of JGB's by the BOJ (see, Table 8-8). However, this policy measure was not without risks, because there were serious concerns about the BOJ's capital adequacy. Higher borrowing costs will create a capital loss for the BOJ. The BOJ was concerned that a substantially

increased balance sheet via the outright purchase of JGBs might impose excessive risks to the central bank's operations. The balance sheet of the BOJ has increased to a large extent and exceeded other major central banks such as the Federal Reserve, and the ECB (Hayami 2004: 300). For fiscal year 2003, the BOJ was confronted with its first operating loss since 1972. Both Governors, Hayami and his successor Fukui, were concerned about the capital structure and its side effects on central bank credibility (Cargill 2006). Considering that the BOJ has not sold any JGB's in the last 30 years, Policy Board member Ueda Kazuo emphasizes that the risks the BOJ has taken with the introduction of quantitative easing policy and buying operations of JGB:

> "As the Bank has been conducting unconventional market operations, it is subject to the risk of incurring several types of capital loss. On its balance sheet, JGBs account for the largest share in the Bank's assets, and as of February 10, 2004, had reached 66 trillion Yen. In contrast, the Bank's capital was just over 5 trillion Yen and thus a 10-per cent fall in the value of JGB holdings due to a rise in interest rates would be sufficient to make it insolvent." (Kazuo Ueda, speech, 25 October 2003).

Government officials repeatedly pressured the BOJ to buy more JGB's. For instance, before the Monetary Policy Meeting on 28 February 2002, the BOJ was subject to intense pressure from the Cabinet to ease monetary policy. In particular, Economy Minister Takenaka and Finance Minister Shiokawa pressured the BOJ extremely. Their arguments were strengthened by the government representatives in the Monetary Policy Meeting, Taniguchi from the MOF and Kobayashi, from the Cabinet Office. Eventually, the BOJ decided to increase the purchase of JGB's from 800 billion to 1 trillion Yen per month (Table 8-8). In the following press conference, Hayami was asked if statements made by the MOF and politicians had influence on the BOJ's independence Hayami, however, avoided giving a clear answer (Fujii 2004: 261-264; Bank of Japan 2002, press conference, 29 February 2002).

Ide (2007) analyses the relation between the Japanese government and the central bank from the viewpoint of fiscal sociology and finds that the political influence from the government was reinforced in the new Bank of Japan Law. In form of the quantitative easing policy in 2001, the BOJ took many risks on behalf of the government, and lost discretionary power over monetary policy. The rise in JGB and CAB, which were not supported by the majority of BOJ officials, demonstrate that the BOJ was required to cooperate with the government. It can be concluded that the relationship between the

BOJ and the government is decided by social, economic, political and historical contexts rather than by legal contexts.

8.7.3.2 Political Pressure during the Termination of the Quantitative Easing Policy

However, as soon as the Japanese economy showed some signs of recovery, the BOJ worked towards ending the quantitative easing policy in order to put an end to cooperation with the government. Beginning 2005, BOJ Governor Fukui has dropped some hints that the BOJ started to consider a termination of the quantitative easing policy. In March 2006, in a hearing before the Upper House of the Diet, Fukui gave a strong signal that the BOJ regarded economic conditions are recovering which justifies an immediate termination of quantitative easing policy (Hisane 2006). Similarly as in the case of the end of the zero interest rate policy, politicians constantly argued that a termination of the quantitative easing policy was premature. Prime Minister Koizumi and Nakagawa Hidenao, chairman of the LDP Policy Research Council (PRC) declared on 8 March 2006 that an end of the quantitative easing policy would be too early (*sôki kaijo*), and could possibly harm the Japanese economy[335] (Suzuki 2006: 26). The government was trying to exert influence on the BOJ, because it feared higher long-term interest rates. Some LDP politicians, including Nakagawa, exerted utmost pressure on the BOJ, and even threatened to amend the BJL on several occasions. Regardless of the strong political pressure, the BOJ was able to resist political pressure, establish a new monetary policy framework, and end the quantitative easing policy. Nakahara, Policy Board member from 1998 to 2002, was convinced that with the termination of the quantitative easing policy the BOJ had changed its policy stance from cooperation towards protecting its independence from the government (Nakahara 2006).

Political pressure continued with the interest rate hike in February 2007 from 0.25 per cent to 0.5 per cent. Nakagawa, promoted to LDP General Secretary in the Abe Cabinet, put an exceptional amount of pressure on the BOJ in January 2007. Nakagawa warned that if the BOJ raised interest rates further the government would see itself forced to make use of its right to request a postponement of monetary policy decision (Oritani 2010: 32; Otsuma 2008). However, the Fukui-led BOJ was unimpressed and raised the

[335] Contrary to this claim is the behaviour of the government. In February, the government upgraded its assessment of the economy for the first time in six months. Literally, the Cabinet Office stated in its monthly report that "The economy is recovering", which is more optimistic than the report in January, which stated that the economy was "recovering at a moderate pace" (Hisane 2006).

interest rate to 0.5 per cent at the Monetary Policy Meeting on 21 February 2007. Fukui's view regarding cooperation with the government was quite clear. At a speech in January 2007, Governor Fukui was asked about his stance toward fiscal-monetary coordination. Literally, Fukui said that "[w]e do not need any." (Bank of Japan 2007; Feldman 2007). This is quite a statement and showed that Fukui was not interested in cooperation with the government. The BOJ's position was unacceptable for some lawmakers. In response to the BOJ's behaviour, Nakagawa threatened to curb the BOJ's independence, blaming the central bank, claiming that the two interest rate hikes it made in July 2006 and February 2007 caused the LDP's defeat in the Upper House election in July 2007 (Hock 2007: 18; Lukauskas and Shimabukuro 2006: 145-147).

8.7.4 Pressure on the Bank of Japan

This section focuses on a general analysis of political pressure on the Bank of Japan, and identifies measures and tools which the government and Diet politicians applied to enforce their demands on monetary policy.

8.7.4.1 Political Pressure on Governor Hayami

According to Article 14 of the BJL, the entire Policy Board has the authority over decision-making of monetary policy. However, similar to many other central banks, the focus is on the central bank leader. The personal responsibility of central bank Governors highlights the hierarchy of power and decision-making in the central bank. That is the reason why mostly the Governors are the target of personal and political pressure.[336] BOJ Governor Hayami provides a good example of the relationship between the central bank and the government, and how a Central Bank Governor can react to political pressure. With the choice of Hayami as successor for the resigned Matsushita, the government aimed to appoint a Governor who could easily be influenced. LDP politicians did not expect that the BOJ would act independently under the leadership of Hayami. In practice, however, the government and politicians were proved wrong and Hayami acted more independently than politicians were hoping for. As Hall (2008: 172) argues, "[i]ndividual central bankers can [...] build up enormous personal authority through leadership with sanguine outcomes during difficult times". Whether Hayami's performance was "sanguine" might be debated, but he turned out to

[336] In this context, Capie et al. (1994: 59) mentioned the personalized attacks on Bundesbank's Dr. Helmut Schlesinger at international meetings between 1992 and 1993.

be a strong leader, and was determined to protect the independence of the Bank of Japan. Realising that Hayami was unwilling to follow the government's economic policy, politicians from the government and Diet initiated a strategy which sought to intensify pressure on Hayami and the BOJ.

Another reason for politicians' intense pressure on the BOJ and Hayami was the fact that the new Governor distanced himself from the LDP during his entire career. During his tenure at the Japan Association of Executives (Keizai Dôyûkai) between 1989 and 1998, Hayami associated himself with opposition parties' leaders, such as Hosokawa Morihiro and Tanaka Shûsei (Arita 2007: 20; Fujii 2004: 41-42). Hayami's cooperation with the with non-LDP lawmakers was criticised by many LDP lawmakers, including Mori, Prime Minister between 2000 and 2001. During his governorship at the BOJ between 1998 and 2003, Hayami continued to remain distant to the LDP, which partly explained the harsh criticism and intense pressure from the government. Hayami not only rebuffed political pressure, but also, on several occasions, he turned the tables and recommended policy measures to the government. For instance, shortly after his inauguration, Hayami advised the government to implement income tax cuts, lower corporate taxes and use more efficient public spending in order to counter the "dark prospects" of the Japanese economy (JT, 7 April 1998). In April 2001, at the 17th meeting of the CEFP, Hayami requested the government immediately realize emergency economic packages (JT, 19 April 2001).

However, Hayami was highly criticized for his communication to financial markets by politicians and market participants. Indeed, Hayami repeatedly made unfavourable statements in press conferences and speeches, which created confusion in the market. For instance, regarding the introduction of quantitative easing policy, Hayami said at a press conference that "[t]he efficiency [of the quantitative easing policy] is far from clear and there are lot of side effects" (Yamawaki 2002: 270). Such a statement is detrimental in building credibility for BOJ's monetary policy, because it openly demonstrates serious doubts on the BOJ's own policies. In addition, Hayami's statements triggered conflicts between the Japanese government and the BOJ.[337]

[337] This is in line with Siklos and Bohl (2005) who identify the communication of a central bank as a main reason of conflicts between governments and central banks.

8.7.4.2 Pressure on Bank of Japan's Governors to Resign

Various politicians from the LDP were unsatisfied with Hayami's performance, and seemingly constantly demanded the resignation of the Governor (*sôsai jinin ron*). Especially after the introduction of the quantitative easing policy in March 2001, demands for Hayami's resignation became harsher and more frequent. Politicians regarded the introduction of the quantitative easing policy as evidence that the termination of the zero interest rate policy in August 2000 was a policy failure (*seisaku no shippai*) on Hayami's part. There were many LDP politicians who believed that Hayami should take responsibility (*sekinin ron*) for the termination of the zero interest rate policy and resign. The pressure for Hayami became really intense.

In April 2001, the media reported that Hayami would resign, which came as a surprise for all market participants (Fujii 2004, Nakahara 2006; Hamada and Noguchi 2005: 37-38). On 26 April 2001, Prime Minister Koizumi announced his new Cabinet, and, the following day, *Yomiuri Shinbun* published an exclusive story (*tokudane*) that the BOJ Governor intended to quit.[338] There are two different explanations for the resignation story. First, some observers argued that this was a strategy used by politicians to put pressure on the BOJ. Angry with the BOJ's claim to combine quantitative easing policy with structural reforms, the government responded with a new strategy, and spread the rumour that Hayami was in bad health and would soon retire. The Financial Times (3 May 2001) reported that BOJ officials promptly accused the MOF and politicians for the disclosure of the resignation narrative. Some unclear remarks from Japan's finance minister and Hayami's silence supported these rumours. In particular, Hayami's continuous struggles with the ruling LDP over monetary policy gave substance to the rumours (Lukauskas and Shimabukuro 2006: 143-144).

A second explanation is that Hayami truly intended to resign. Facing constant political pressure from Prime Minister Mori and other lawmakers exhausted him, and the plan to retire from the post of BOJ Governor arose. In April 2001, an election of the Prime Minister took place and former Prime Minister Hashimoto Ryûtarô was the favourite candidate. Hashimoto's faction was particularly critical against Hayami. However, Koizumi Junichirô won the election of the LDP president (*jimintô sôsai sen*) and

[338] In Japanese: "*Hayami nichigin sôsai ga jii. Kenkô fuan riyû ni, kônin, Fukui gen fuku sôsai wo jiku ni*" (Yomiuri Shinbun, 27 April 2001).

became Prime Minister. As a result, the situation had changed significantly for Hayami. Koizumi and Hayami had known each other since Hayami's tenure at the Keizai Dôyûkai (Fujii 2004: 214), and both were members of a study group with Hosokawa Morihiro and Tanaka Shûsei. The new Prime Minister and the BOJ Governor seemed to share the same goal of structural reform, and it can be argued that Hayami lost his intention for resignation. In addition, finding a new and suitable candidate for a central bank's head is a costly issue for a government, and the Koizumi administration did not have the time to select a new BOJ Governor (Arita 2007: 25).

Hayami, who attended the G7 Finance Minister and Central Bank Governors meeting in Washington on 28 April waited until May to clear up the rumours. He denied all resignation rumours, stating that he never intended to step down from the position of Governor ahead of schedule. Hayami stated that "I would like to serve out my term as long as my health permits" (JT, 10 May 2001; Fujii 2004: 212-213; Nakahara 2006: 182-183; 195). Hayami's statement could be interpreted as that he never really intended to resign, which coincides with the first explanation. However, it is also visible that Hayami tried not to lose his countenance in that affair, meaning that he simply wanted to avoid the impression that the government's pressure on the Governor was successful. In the end, it is impossible to verify which explanation is correct, but it is evident that Hayami's reputation was harmed by that incident.

Similar to Hayami in May 2001, Fukui experienced his own resignation ordeal in June 2006 (*Fukui sôsai taijin ron*). Voices from the government, Diet politicians and in the public supported the view that Fukui should be fired should the BOJ decide to further interest rate hikes (Motoyoshi 2006: 88-89). It was astonishing that at that exact time a story was revealed in which Fukui was involved in a scandal regarding an investment in the Murakami fund. After Murakami Yoshiaki, a former Ministry of Economy, Trade, and Industry bureaucrat, was accused and arrested for insider trading, Fukui confessed that he invested ten million Yen in Murakami's fund in 1999 during his tenure at Fujitsu Research, and kept it even after becoming BOJ Governor in 2003. The Japanese media was surprisingly quiet in reporting critically about Fukui's financial scandal. However, the general public was not so patient with the Governor. A survey by the *Asahi Shinbun* showed that the majority of the public, namely 67 per cent, called for Fukui's resignation. Most interestingly, Fukui was supported by Prime Minister Koizumi, the

government, and leading ruling party politicians, who arguably saved his skin. How can the strategy of Koizumi and the government to support Fukui be explained, although Fukui started to end the silent cooperation with the government and terminated quantitative easing policy in March 2006?

It can be argued that the Murakami fund scandal weakened the position of the Fukui-led BOJ against the government. Arguably, the Koizumi administration could have intended to force Fukui to return to a cooperative stance with the government after they had saved him from resignation. After the scandal, it was difficult for Fukui to exert leadership in the BOJ. Following the government's demands would have raised the assumption that Fukui was indebted to Koizumi. The whole scenario afterwards made it difficult for the BOJ to act independently. The decision to raise the interest rate in July 2006 can be understood as an attempt made by Fukui and the BOJ to demonstrate independence. Due to the scandal with the Murakami fund, the BOJ was caught in an unsure state of dependence and subject to external pressure and control. In the end, Policy Board members believed that they would lose the market's trust if they did not raise rates at this time.[339] In other words, Fukui was trapped in a serious dilemma. Any policy measure he made could have been interpreted as having been influenced by the government. If he supported government policy, it was easy to argue that Fukui had to follow government's demands. In case of a different monetary policy, it would have been possible to state that the BOJ needed to prove that it could still act independently after the scandal (Harui 2006; Kajimoto 2006; Takita 2006).

8.7.4.3 The Bank of Japan's Parliamentary Hearings

As previously demonstrated, the new BJL requires the BOJ to report and to justify its policy decisions before the Diet on a regular basis (Article 54, Paragraph 3). Regular appearances before parliament are an essential factor of a central bank's accountability (see, Chapter 6). Sterne (2000: 100) argues that "accountability is sometimes achieved through very frequent parliamentary monitoring." This section focuses on the question how the Japanese government interpreted and employed Article 54 that requires the BOJ to report before the Diet.

[339] In Japanese: "*kaijo shinakereba nichgin ni tai suru shijô no shinrai ga ushinawarete shimau*."

In practice, it turned out that the government frequently requested a Governor's appearance before the Diet, especially in the case of Hayami. It can be argued that this right was abused by politicians since the beginning of the new BOJ. In comparison to the procedure under the old law, there was a major change. Before the Bank of Japan Law revision, the BOJ Governor only had to appear before the Diet approximately ten times a year (Nakao and Horii 1991: 18). In his first year as Governor, in fiscal year 1998, Hayami had to appear before the Diet a total of 106 times (Sterne 2000: 75), although the BOJ had eased monetary policy with interest rate cuts and the introduction of zero interest rate policy. Both policy measures were claimed by the government. It is possible to say that there was no urgent need for the government to force the BOJ to report before the Diet so often just to confer on monetary policy operations. Thus, the government's behaviour can be interpreted as an attempt to demonstrate its authority by refusing to allow the Bank to act independently.

Nakahara (2006: 125-126) reports that around August 2000, when the BOJ planned and finally decided to terminate the zero interest rate policy, Hayami was called before Diet exceptionally often. Hayami had to explain his view on the condition of the Japanese economy and deflation pressures. Needless to say, the government had a different view, and used the Diet hearings to exert pressure on Hayami. In a speech at the Keizai Club in Tôkyô on 25 February 2003, Hayami stated that "the number of times I appeared in the Diet to answer questions during my term of office up to January was 382" (Hayami 2003). The *Asahi Shinbun* (9 April 2008) reported that Hayami was called before the Diet 450 times during his five-year term. Notably, during some periods he was requested to appear more than once a day.

Most of the time, Hayami endured the permanent hearings and questionnaires before the Diet very patiently. One time he was grilled by one of his main critics, LDP lawmaker Masuzoe Yôichi. When asked about the economic failure to end zero interest rate policy in August 2000, Hayami insisted that the end of zero interest rate policy was not a mistake, and that the economic conditions had simply changed. After that hearing, it was reported that Masuzoe lost his motivation to criticise and attack the BOJ, arguing that Hayami was particularly obstinate, and always gave poor answers (*o somatsu*) (Nakahara 2006: 205). Like Masuzoe, an increasing number of Diet members regarded the questionings of the Governor as ineffective. Indeed, requests of the government to

Hayami became less frequent, reducing to only 36 times in fiscal year 2002 (Table 8-9). After Fukui became Governor in 2003, the government's request of the Governor's and other Board members' attendance before Diet sank noticeably, averaging between 30 times a year in 2005 and 2007 and 39 times a year in 2003 (Table 8-9). Nevertheless, it is evident that Bank of Japan officials had to appear before the Diet more often than officials of other major central banks such as the US Federal Reserve or the European Central Bank (Table 8-10).

Table 8-9: Testimony of BOJ officials before Diet

Fiscal Year	Frequency of Appearance before the Diet
2002	59 (36)
2003	39 (23)
2004	35 (27)
2005	30 (17)
2006	31 (23)
2007	30 (17)
2008	45 (28)
2009	29 (15)
2010	30 (20)
2011	41 (30)
2012	31 (23)

Source: BOJ, Annual Review 2002-2012 and BOJ website[340]
Note: The number in parenthesis is the number the Governor appeared before Diet

Table 8-10: Comparison of Testimony before Diet[341] between the BOJ, ECB, and the US Federal Reserve

Year	BOJ	ECB	Fed
2005	33 (20)	5 (5)	21 (13)
2006	35 (25)	5 (5)	15 (6)

Source: Shirakawa (2008: 243)
Note: The number in parenthesis is the number of the Governor (President, Chairman respectively) appeared before Diet (European Parliament, Congress respectively)

Between 1998 and 2001 Hayami's attendance was repeatedly requested by the government even during Monetary Policy Meetings. On several occasions, Hayami

[340] (http://www.boj.or.jp/announcements/kokkai).
[341] Respectively, the European Parliament and Congress.

missed the beginning of the Board's meetings, because his presence was required at a meeting of the Ministerial Council, which discussed the Economic Planning Agency's Monthly Economic Report (*getsurei keizai hôkoku*) (Table 8-11). On several other occasions, e.g., on 16 July 1999, Hayami was absent in order to attend a session of the Diet. In case of Hayami's absence, Deputy Governor Fujiwara performed the duties of the chairman in accordance with Article 16, Paragraph 5 of the Bank of Japan Law. Due to the intense demand by Diet members to question Governor Hayami, Hayami was forced to shorten several Monetary Policy Meetings. Not only the Governor, but, on some occasions, a Deputy Governor was also called to report before the government or Diet. Table 8-12 lists all other Policy Board members, who were requested by the government to attend Monetary Policy Meetings. Interesting to note is the fact that they were all Deputy Governors. [342] After Hayami's retirement in 2003, the government's requests for the attendance of leading figures of the BOJ or others during Monetary Policy Meetings became less frequent. Altogether, they only demanded appearances four times.

Table 8-11: Absence of Governor Hayami from Monetary Policy Meetings

Date	Missing time	Reason for absence
11 August 1998	9:00 to 9:22	Meeting of the Ministerial Council which discussed issues including the Economic Planning Agency's Monthly Economic Report.
9 September 1998		The MPM was recessed due to Hayami's attendance at a Diet session
19 January 1999	9:01 to 9:17	Meeting of the Ministerial Council
16 July 1999	9:42 to 10:54	Diet session
17 December 1999	9:00 to 9:09	Meeting of the Ministerial Council
14 September 2000	9:01 to 10:20	Meeting of the Ministerial Council
15 December 2000	9:00 to 10:14	Meeting of the Ministerial Council
19 January 2001	9:00 to 10:38	Meeting of the Ministerial Council

Source: Own compilation on basis of Minutes of Monetary Policy Meetings, Bank of Japan.

[342] Here, it is not totally clear if the government requested that very Deputy Governor, or, if the Deputy Governor just replaced the Governor.

Table 8-12: Absence of Policy Board Members from Monetary Policy Meetings

Date	PB Member	Reason for Absence
25 February 1999	Fujiwara	Diet session
19 March 2001	Fujiwara	Diet session
5 March 2003	Fujiwara	Diet session
19 January 2006	Iwata	Meeting of the Ministerial Council
19 December 2006	Iwata	Ministerial meeting on economic measures
8 April 2008	Shirakawa	House of Councillors
15 November 2011	Yamaguchi	House of Councillors, Budget Committee

Source: Own compilation on basis of Minutes of Monetary Policy Meetings, Bank of Japan.

In sum, the empirical data shows that the Japanese Government employed its right to make BOJ Policy Board members, in particular the Governor, appear before the Diet extensively to put pressure on the BOJ. Especially, Governor Hayami was called before the Diet extremely often, which can be explained by two reasons. First, the government wanted to make clear that it still had power over the BOJ and that the central bank could not act entirely independent from the government. Second, Governor Hayami turned out to be a central banker whose own idea of monetary policy differed strongly from that of the government, and, thus, he was forced to explain his monetary policy before the Diet more often than usual. We observe a shift in the frequency of Diet hearings after Fukui took over the helm of the BOJ in 2003. The same can be said for Shirakawa, who assumed the position in 2008. However, it turned out that the government's strategy had only limited success in influencing monetary policy. Only in combination with other pressure, was it sometimes possible for the government to force the BOJ to act more in line with its demands. The following section analyses government representatives in the Monetary Policy Meetings of the Bank of Japan.

8.7.4.4 Government Representatives in Monetary Policy Meetings

According to Article 19 of the Bank of Japan Law, the government has the right to send two representatives to attend Monetary Policy Meetings of the BOJ; one from the MOF and the other one from the Economic Planning Agency (since 2001 from the Cabinet Office) (see, Chapter 5). These two representatives may express views and submit proposals regarding monetary policy (BJL, Article 19, Paragraph 2).

It is most interesting that Finance Minister Matsunaga attended the first Monetary Policy Meeting of the BOJ under the new BJL on 9 April 1998. Why should the Finance Minister attend a Monetary Policy Meeting of an independent central bank? The reason for this was made clear in a statement by Matsunaga, before the start of the meeting in which he declared how the government expected the BOJ to act:

> "As stated in the new Bank of Japan Law, […] *it was important for the Bank's monetary policy and the basic stance of the government's economic policy to be mutually harmonious.* In this regard, the Monetary Policy Meeting would be a useful opportunity for the Bank of Japan and the government to exchange views. […] It was important that the Bank of Japan, for its part, should reduce financial institutions' anxiety about financing difficulties *by supplying ample funds to the money market.*" [sic] (Bank of Japan, Minutes of MPM, 9 April 1998, italics added).

The Finance Minister's claims were repeated by the second government representative Omi Kôji, Director General of the Economic Planning Agency (Bank of Japan, Minutes of MPM, 9 April 1998). The government had planned in advance that the Finance Minister and the Director General of the EPA should attend the very first Monetary Policy Meeting in order to express what is expected of the BOJ, namely to keep close contact to the government, and, in more detail, to provide ample funds to the financial market. Of course, this put intense pressure on the central bank, and weakened its independence, especially because this statement was formulated by the Finance Minister. If studying the Minutes of the Monetary Policy Board Meetings it becomes evident that even incumbent Cabinet Ministers joined the meetings on several occasions, although this practice was highly uncommon under the old BOJ Law. In addition, on some occasions, government representatives took the chance to make remarks before the Monetary Policy Meeting had started, which can be interpreted as another form of exercising pressure on the central bank. Another measure of the government to put pressure on the BOJ was to send more than two representatives, who appeared alternately, arguably disturbing a smooth procedure of the Monetary Policy Meeting.

At the Monetary Policy Meeting on 12 June 1998, approximately two months after the new BJL took effect, the government reduced BJL Article 19 to the absurd. The MOF sent Deputy Vice Minister for Policy Coordination Mutô Toshirô to the Monetary Policy Meeting. The EPA was represented by three different officials who came one after another alternately. Kurimoto Seiichirô, Parliamentary Vice Minister, joined from

9:00 a.m. to 10:46 a.m., followed by Omi Kôji, Director General, from 10:50 a.m. to 11:17 a.m.. Finally, Shioya Takahide, Director General of the Coordination Bureau, attended from 12:17 p.m. to 5:56 p.m. (Bank of Japan, MPM 12 June 1998). Policy Board member Nakahara (2006: 39-40) was quite irritated by the government's harassment, presuming that the government disregarded the seriousness of the BOJ's Monetary Policy Meetings. This procedure was repeated at the Monetary Policy Meeting on 12 February 1999, at which the zero interest rate policy was decided upon. Here, both the MOF and the EPA sent two representatives who alternated when they were present. This behaviour can yet again be interpreted as a deliberate move of the government to strengthen its authoritative position, and to maintain ongoing pressure on the BOJ.

The Japanese Government continued this strategy until 2001, and requested the BOJ implement strong easing monetary policies. The minutes of the Monetary Policy Meetings show that before the introduction of the quantitative easing policy (19 January 2001; 9 February 2001), the government sent four government representatives. During the period of quantitative easing policy, the government continuously put pressure on the BOJ to ease monetary policy further. For instance, Deputy Minister of Finance Taniguchi Takayoshi attended the Monetary Policy Meetings from December 2002 to March 2003, and permanently requested the BOJ increase its outright purchases of JGB.

Takenaka Heizô can be identified as a source of strong political pressure during the period of the quantitative easing policy. Takenaka was the Minister in charge of economic and fiscal policy (*keizai zaisei seisaku tantô*; short: Economy Minister) from 2001 to 2005. He was known for advocating structural reforms and privatization. In addition, he was a strong supporter of the implementation of an inflation target (IT, *infure tâgetto*), and tried to convince BOJ officials and politicians of the advantages of this strategy.[343] Especially after Takenaka was appointed to head the FSA in September 2002, he tried to increase the coordination of the FSA with the BOJ (Hoshi 2004). Takenaka exerted intense pressure on the BOJ to further ease monetary policy. For instance, Takenaka joined several Monetary Policy Meetings of the BOJ in order to

[343] In 2001, there was a heavy public debate of Economy Minister Takenaka and Finance Minister Shiokawa over inflation targeting. Takenaka supported the idea of an inflation target, whereas Shiokawa argued that inflation targeting bear the risk of uncontrollable inflation. Governor Hayami clearly opposed the idea, commenting that "I've never hared of a more stupid policy [than IT]" (JT, 15 August 2000).

express his opinions on monetary policy. Usually, incumbent members of the Cabinet refrained from participating in Monetary Policy Meetings, and preferred to send representatives instead. It can be argued that there a strong reasons for a Cabinet minister to attend a Monetary Policy Meeting, all of which aim to strengthen the position of the government. Takenaka participated in Monetary Policy Meetings a total of 14 times; nine times in 2001 (continuously from 15 June 2001 to the end of 2001, except 29 October), four times in 2002, and one time in 2003.[344] This is ample evidence that Takenaka was especially determined to pressure the BOJ towards easing monetary policy. The first meeting Takenaka participated was on the 15 June 2001. Here, he emphasised the necessity of cooperation between the BOJ and the government. Takenaka demanded a "harmonization" of the fiscal and monetary policy and requested the BOJ increase the amount of CAB. At the same time, he pointed out that the government was willing to implement structural reforms. Takenaka made following remarks in the Monetary Policy Meeting on 15 June 2001:

> "When advancing structural reforms, it would be important to minimize the deflationary pressure to the greatest possible extent within the severe fiscal constraints. The Government would make efforts to establish a concrete program of structural reforms. Therefore, the Government would like to ask the Bank to conduct monetary policy in harmony with other policy actions from the standpoint of utilizing all possible policy measures […] the Government would like to ask the Bank to conduct monetary policy in a flexible manner, taking into account the deflationary pressure during the adjustment period." (Bank of Japan, MPM, 14-15 June 2001).

In the subsequent Monetary Policy Meeting on the 12 and 13 July 2001, Takenaka requested the BOJ to take additional measures in order to influence the expectations of the markets and the public, aiming to dispel deflationary concern. Furthermore, the Economy Minister wanted the Bank to discuss the issue of real interest rates. BOJ Governor Hayami took Takenaka's demands as an affront to the BOJ's independence. He rebuffed the requests with the following four reasons (Bank of Japan 2001, MPM, 12-13 July 2001):

> 1. The points mentioned by the Government representatives above [Takenaka and Fujii] had been continuously discussed by the Board. The Board bore the Government's remarks in mind, and continued to have

[344] See, minutes of the Monetary Policy Board meetings (Bank of Japan).

thorough discussions regarding which monetary policy decisions were appropriate to make.

2. As there was hardly any room left for conventional monetary policy measures, the effects, including side effects, and the feasibility of possible monetary policy measures should be examined carefully.

3. The Bank hoped that the Government understood the Bank was doing its utmost to explore every avenue in discussing the best monetary policy based on its view that the economic situation was severe, and would welcome constructive suggestions by the Government at Monetary Policy Meetings.

4. The Bank would continue to make efforts to conduct appropriate monetary policy as a central bank, and, at the same time, strongly hoped that the Government would push ahead with its efforts to advance its concrete plans for structural reforms.

Hayami's statement was clear evidence that the BOJ was not willing to cooperate with the government. Takenaka was upset about Hayami's and the Policy Board's reluctance to further ease monetary policy, and continued to exert intense pressure on the BOJ. He announced in advance that he intended to participate at the upcoming Monetary Policy Meeting on 14 August 2001, stating that "I will attend [the MPM] and will say what I have been saying till now". Indeed, this time the Policy Board decided to further ease monetary policy, and increased the targeted reserves from five to six trillion Yen. The outright purchase of long-term government bonds increased from 400 billion Yen to 600 billion Yen (Bank of Japan, MPM 14 August 2001). In the subsequent press conference, even Hayami did not exclude further easing in the near future. This was an important moment for the relationship between the government and the BOJ. One might assume that government pressure was successful, because one month earlier Governor Hayami's rhetoric was the opposite, and the Governor said that further easing is not necessary.

Evidence for the success of government pressure was a statement made by Takenaka. He said that if the BOJ had not consented to monetary easing, the government would have eventually forced the BOJ to obey (JT 15 August 2001). This strongly indicates that the government would have used Article 19, Paragraph 2 of the BOJ Law, namely

the request of a postponement of a monetary policy decision with the submission of an own proposal. After the circumstances of the termination of the zero interest rate policy, this would have been a strong threat to the BOJ as the BOJ's decision to abandon the zero interest rate policy was commonly viewed as a policy mistake by the majority of observers (Itô 2004, 2006). Another overrule of the government by the BOJ would have done enormous harm to the BOJ in case of a policy mistake. In sum, it can be argued that governmental pressure, especially that exercised by Economy Minister Takenaka was successful this time.

As already demonstrated, after Fukui was appointed Governor in March 2003, the BOJ adopted a more cooperative stance with the government. As a result, pressure from government representatives in Monetary Policy Meetings became less frequent and less intense after Hayami's term ended. Thus, it can be argued that the government's strategy to exert direct pressure in Monetary Policy Meetings was particularly prominent during the governorship of Hayami. The following section briefly compares the government's attitude towards Governors Hayami, Fukui and Shirakawa.

8.7.4.5 Comparisons between Governor Hayami, Fukui and Shirakawa

As already discussed, Fukui replaced Hayami as BOJ Governor in 2003. After approximately one year in office, Fukui gained a high reputation in the media, and with analysts and economists. The *Economist* (12 February 2004) even went as far as to refer to Fukui as the best central banker in the world, whereas, his predecessor Hayami was labelled quite the opposite, namely as "quite possibly the world's worst central banker". These very different evaluations deserve a clarification.

Once in office, Fukui adopted a less confrontational approach and was determined to develop good relationships with the government and politicians. On various occasions, Fukui demonstrated that he was very skilful in communicating with politicians and the public. He was able to make politicians and the public believe that he fully intended to combat deflation pressures. Especially in the beginning of his tenure, Governor Fukui was willing to take more risks in using unorthodox monetary policy tools. Indeed, it is evident that under the leadership of Fukui the BOJ aggressively fought deflation, and printed much more money (Table 8-8) (Fukui 2003; Pascha 2005a; Hamada and Noguchi 2005; Itô 2004, 2006). Regarding the introduction of an inflation target, Fukui

skilfully announced that he was not against inflation targeting in principal, but that it would be a rather inappropriate move at that time (Fukui 2003). With these kinds of statements, Fukui successfully stayed away from conflicts with supporters of inflation targeting, including Economy Minister Takenaka. This example showed that he was able to placate politicians in order to avoid unnecessary confrontations with politicians that could have been unfavourable for the BOJ in the long-run. The change in the Bank's communication with the public was of even higher significance. Hayami's rhetoric was criticised to a high extent by many observers, and caused confusion in the financial market on some occasions (Itô 2004, 2006). For instance, in September 1998, when the Policy Board decided to cut the key interest rate to 0.25 per cent, explanations regarding the duration and the future path of lower interest rates lacked clarity. Observers argued that policy explanations by the BOJ were not sufficient for a transparent central bank (Fujii 2004: 88-89). Another example is the quantitative easing policy. When quantitative easing policy was implemented in March 2001, Hayami's statements indicated that he was not convinced that the new policy measure could be successful in overcoming deflation. Since expectations played a major role in regards of future inflation, Hayami's public speaking did not help to enhance the credibility and trustworthiness of the new monetary policy framework.

In contrast to Hayami, Fukui's communication strategy was much more optimistic in terms of the efficiency of the BOJ's monetary policy. Fukui stressed the effectiveness of the quantitative easing policy, and he made credible commitments, stating that the BOJ would continue easy money conditions until the CPI became positive, or at least reached zero. In the beginning of his tenure, Fukui credibly convinced the public that the BOJ was determined to fight inflation, and continue zero interest rates until deflation concerns were dispelled (Itô 2004: 4; 2006). Fukui was aspired to maintain quantitative easing policy as long as necessary (Fukui 2003). Observers agreed that Fukui's statements were much more credible than Hayami's (Fujii 2004: 292). Moreover, Fukui acted much more diplomatic than his predecessor, and "the confrontational style with the government [under Hayami] has melted away." The new Governor anticipated that cooperation with the government did not automatically mean bowing to political influence. In sum, the new chairman preferred a looser monetary policy, and, under his regime, the BOJ injected much more liquidity in the financial market than before, which gained support from the political side (Pascha 2005a).

However, one has to find out to what extent and during which period Governor Fukui cooperated with the government and politicians. Hamada and Noguchi (2005: 41) found that "[i]n addition, the BOJ under Fukui's direction cooperated with Ministry of Finance in supporting numerous exchange rate interventions that intended to minimize the abrupt appreciation of the Yen in the fall of 2003. The BOJ implemented the expansion of quantitative easing, in order to assure that exchange market interventions would be de facto unsterilized interventions." In this case, it can be argued that the Fukui-led BOJ cooperated with the MOF like in former times, i.e., before the BJL revision. Taking these examples into consideration, it can be argued that the policy stance by the BOJ and the government was similar. However, Fukui was not permanently supportive towards easing measures such as quantitative easing policy. Nakahara (2006: 183) reports that Fukui's standpoint towards quantitative easing policy changed after he became BOJ Governor. Still in 2001, Fukui argued against easing measures, and published a paper which harshly criticised quantitative easing policy. However, after becoming Governor in 2003, Fukui soon started to raise the amount of CAB (Table 8-8). How can this change of the Governor's mind be explained? Prime Minister Koizumi and the government made their standpoint clear, and, before appointing a new Governor in 2003, they unmistakeably expressed that they expected easing monetary policy measures from the new Governor. In other words, they demanded the Governor make what they regarded as the utmost effort to stop deflationary pressures. Politicians threatened that they would extend pressure on Fukui and the BOJ should he not be willing to follow government demands. Thus, in order to be promoted to BOJ Governor, Fukui was forced to change his beliefs towards the government's economic policy. In addition, in order to control Fukui, the Koizumi Cabinet appointed two Deputy Governors who were very close to the government. With the appointment of two Deputy Governors, one from the MOF and the other from the Cabinet Office, Fukui's independence was limited to a high extent.

Are the above-mentioned reasons sufficient to explain how a career BOJ man like Fukui could act in line with the government's ideas and policy preferences? Pascha (2005a: 20) argues that "the very label of a BOJ old boy [of Fukui] may have enabled him [Fukui] to switch to a more pro-government policy without a loss of face." However, a study of the minutes of Monetary Policy Meetings demonstrate that the Fukui-led BOJ

had already worked towards the termination of quantitative easing policy (*ryôteki kanwa seisaku no deguchi ron*) since the summer of 2003, which was shortly after Fukui's inauguration (Fujii 2004: 295-296). This means that the cooperative stance of Fukui to the government was only temporary and due to pressure at the beginning of his appointment. Indeed, in 2005 Fukui stopped cooperating with the government, announcing that the BOJ would abandon quantitative easing policy as soon as the economic conditions improved. The Fukui-led BOJ terminated quantitative easing policy in 2006, and raised interest rates in 2006 and 2007. As a result, the government's positive assessment of Fukui radically changed, especially after the second interest rate hike in February 2007. They criticised his willingness to tighten monetary policy too prematurely. As a consequence, many financial experts and BOJ watchers argued that the overall difference in monetary policy between Hayami and Fukui was not as big as observed in the beginning of Fukui's term.[345]

Analysing government pressure from 2008 on, after Shirakawa became Governor of the BOJ, Dwyer (2012) argues that under Governor Shirakawa political pressure had been most intense. One reason was that economic conditions had worsened due to the Lehman Shock in September 2008, and the subsequent global financial crisis. Although Shirakawa has introduced a wide range of unorthodox monetary policies, including the outright purchase of commercial papers (December 2008), outright purchase of corporate bonds (January 2009), and purchases of stocks held by financial institutions (February 2009), economic conditions did not improve notably. However, many Japanese politicians argued that the central bank's response to the crisis was too small, and pressured the BOJ to do more against the deflation and the high Yen. However, like Fukui, Shirakawa was able to build relatively good contacts with key political figures, i.e., he had regular meetings with the Prime Ministers. The government insisted on regular meetings with the central bank Governor in which Cabinet members formulated their viewpoint on monetary policy. For example, soon after becoming Prime Minister, Hatoyama met with Shirakawa on 1 September 2012, even before meeting top bureaucrats from the Ministry of Finance (Tango Yasutake) and the FSA. This clearly demonstrated how important the BOJ was for Prime Minister Hatoyama.[346] However, political pressure was not only exercised by the government. Based on the analysis of a

[345] Interviews with monetary experts between 2007 and 2009.
[346] The *Yomiuri Shinbun* viewed the story so important that they published this story on page one.

principal-agent framework with multiple principals at the beginning of this chapter, the following sections focus on the analysis of political pressure implemented by the legislative branch, namely certain Diet politicians.

8.7.4.6 Political Pressure by Diet Politicians

There is plenty of evidence that Japanese Diet politicians mobilized an extraordinary amount of pressure on the BOJ. Arita (2007: 25) argues that political pressure increased the moment a power shift from the government to ruling party politicians took place. Lawmakers found it much easier to blame and put pressure on the BOJ if they were not members of the Cabinet. How did it come to a power shift and stronger party politicians from the Diet?

After Prime Minister Obuchi was suddenly hospitalised in April 2000, LDP leaders decided in a secret meeting that Mori Yoshirô would be appointed as the following Prime Minister. However, Mori and his Cabinet turned out to be particularly unpopular among the electorate. One important reason for this was that Mori was not democratically elected by the voters, and they felt blindsided by politicians. In addition, the contents of a series of speeches by Mori before the election were viewed as critical by the electorate, which significantly affected his popularity negatively (Kabashima and Imai 2002). This unpopularity was dangerous for the Mori Cabinet, and made the Prime Minister highly dependent on party legislators. As a consequence, Mori found himself forced to accept requests from lawmakers in the Diet. One key figure of the Mori administration was Kamei Shizuka, Chairman of the LDP's Policy Research Council (*jimintô seimu chôsa kaichô*). It was astonishing that Kamei was assigned the management of economic policy, and not Finance Minister Miyazawa. Kamei was known to advocate both large public spending and easy monetary policy. As a fierce supporter of quantitative easing policy, he constantly put pressure on the BOJ to introduce quantitative easing policy, and, after it was implemented, urged the BOJ to increase the amount of CAB (Arita 2007).

However, pressure from LDP Diet members was common already before Mori became Prime Minister. On 27 January 2000, the LDP's "Committee for Investigation of Financial Problems" (*jimintô kinyû mondai chôsa kai*) decided to establish a working group that would investigate inflation targeting, and pressure the BOJ to introduce

inflation targeting. In response to the committee's claim, the BOJ's Policy Board discussed inflation targeting at the Monetary Policy Meeting on 10 February 2000. However, most Policy Board members argued against the introduction of an inflation target, and showed no intention to adopt it in the near future (Bank of Japan, MPM 10 February 2000). The Committee maintained its pressure on the BOJ, and, on 13 July 2000, LDP lawmakers from the Committee fiercely opposed the termination of the zero interest rate policy, and tried to hinder an interest rate hike, which the BOJ was planning to decide upon in the upcoming Monetary Policy Meeting on 17 July 2000. In more detail, pressure was especially focused on certain central bankers, including Masubuchi Minoru, BOJ Executive Director, and Maehara Yasuhiro, Advisor to the Governor, Secretariat of the Policy Board (*seisaku iinkai shitsu shingiyaku*). Both were requested to attend a meeting of the Committee. After the meeting, Masubuchi and Maehara communicated the demands of the group for an enhanced easing monetary policy to Hayami (Nakahara 2006: 123; Nikkei, 14 July 2000). It can be argued that the Committee's pressure had an impact on the BOJ's decision to postpone its intention to end the zero interest rate policy in August 2000. However, one month later, the pressure of the Committee was not successful, and, this time, the BOJ decided to end the zero interest rate policy. The pressure was strong, and members of the Committee did their best to impede the decision of the BOJ to raise interest rates. On 9 August 2000, Diet members, including Yamamoto Kôzô and Watanabe Yoshimi of the LDP together with some businessmen and economics Professors, published a report called "The BOJ Should Not Hasten to Terminate the Zero Interest Rate Policy" (*Nichigin ha, zero kinri kaijo wo isogu beki de nai!*). This report claimed that a termination of the zero interest rate policy was too early, because the economy had not fully recovered. Yamamoto argued that "the economy is at a very delicate stage and not necessarily on a full-fledged recovery track […] To abandon the zero interest rate policy at this point would do enormous harm" (JT, 10 August 2000; Yamamoto 2010: 159-162). However, regardless of heavy pressure by Diet politicians to continue the zero interest rate policy, the Bank remained strong and independent, and decided to raise the key interest rate to 0.25 per cent in August of 2000.

From this point on, the Committee changed its strategy, and even intensified pressure. Unsatisfied with the BOJ's monetary policy, some influential LDP Diet members started to request the resignation of Hayami. On 30 November 2000, a member of the

Committee raised the question whether Hayami had to be fired in case the economy worsened so much that the zero interest rate policy had to be reinstalled (Fujii 2004: 184). In February 2001, Yamamoto, the chair of the Committee, publicly requested the resignation of Governor Hayami (Nakahara 2006: 157-158). Another issue was monetary policy, and various Diet politicians actively proposed their views towards a less strict monetary policy. On 5 March 2001, Kamei requested BOJ official Horii Akinari to inform Hayami that many politicians wanted the BOJ to implement quantitative easing policy[347] through the purchase of JGB in order to fight deflationary pressures (Arita 2007: 24; Nikkei, 5 March 2001).

In sum, it can be argued that political pressure urged the BOJ to implement quantitative easing policies. However, even after the BOJ's implementation of the quantitative easing policy in March 2001, pressure from Diet politicians remained high. In particular Yamamoto, Watanabe and Masuzoe, who were at the forefront of criticising the BOJ, increased the pressure, and the situation became increasingly unpleasant for the BOJ (Nakahara 2006: 190). In July 2001, Masuzoe demanded Prime Minister Koizumi, who had just achieved an overwhelming victory in the July 2001 Upper House election, to urge the BOJ to introduce an inflation target. Finally, on 14 August 2001, the BOJ eased its monetary policy, although it had continuously resisted further easing measures since the introduction of quantitative easing policy. The Bank announced that it would increase its monthly purchases of JGB to 600 billion Yen, and increase the CAB from five to six trillion Yen (Table 8-8). However, pressure on the BOJ to influence monetary policy decisions was not enough. More and more LDP politicians intensified their pressure, and threatened to revise the BOJ Law to cut off the BOJ's independence. This is a very strong tool which can be used against the central bank, and make it more dependent on the government. Japanese Diet politicians used this tool, which will be the subject of the following section.

8.7.4.7 Threats to Revise the Bank of Japan Law

Threats to revise the Bank of Japan Law had been made since 1999. However, after the BOJ made the decision to abandon zero interest rate policy in August 2000, the demand became more concrete, and LDP lawmaker Watanabe Yoshimi stressed the need to

[347] Literally, Kamei stated that "I realize you are struggling, but I would ask you to do quantitative monetary easing. Please consider that." [sic]

"open the discussion for revising the BOJ Law again" (*nichgin hô saikaisei mo shiya ni irenakereba naranai*) in order to strengthen the position of the government and the Prime Minister over the central bank, and so as to restrict the BOJ's independence (Watanabe 2000; Nikkei, 12 August 2000). In 2001, political pressure towards law revision was exceptionally intense. In February 2001, the Treasury and Finance Division under the Policy Research Council (PRC) decided to establish a project team which had the task to investigate the current BJL. After the implementation of the quantitative easing policy in March 2001, demands to revise the current BOJ Law again (*nichgin hô saikaisei no giron*) became even stronger. Key figures of the PRC were Yamamoto and Watanabe. Basically, this group requested following five amendments of the BOJ Law (Fujii 2004: 215-216; Arita 2007: 24).

1. The right of postponement of a monetary policy decision[348] (Article 19)
2. The introduction of an inflation target (Article 15)
3. A clear definition of cooperation between government and BOJ (Article 4)
4. The revision of the process for selecting the Governor, Deputy Governors, and Policy Board members (Article 23)
5. The Prime Minister should have the power to dismiss the Governor (Article 23)

Regarding the introduction of an inflation target, the opinion was split between politicians. Proponents of inflation targeting were Economy Minister Takenaka Heizô, Finance Minister Shiokawa Masajûrô, Yamazaki Taku, LDP General Secretary, and Yamamoto Kôzô. In contrast, Prime Minister Koizumi, LDP Policy Chief Asô Tarô, Katô Kôichi, former General Secretary LDP, and Noda Takeshi, General Secretary of the New Conservative Party (NCP, *Hoshutô*) were politicians with a more cautious stance towards the introduction of an inflation target (Yoshizaki 2001). Owing to this disunity, it was much easier for the BOJ to reject the implementation of inflation targeting.

In August 2001, another task force of the ruling LDP was formed to investigate the Bank of Japan Law (*nichigin hô kenkyû kai*). This group strengthened the demand to cut

[348] Regarding this claim, the Bundesbank Act was cited as role model

the BOJ's independence on basis of the argument that the revised BOJ Law of 1998 had formed an overly independent central bank. The group consisted of 26 politicians, including Yamamoto Kôzô, who acted as president, Aizawa Hideyuki (both former MOF bureaucrats), Watanabe Yoshimi and Masuzoe Yôichi. Basically, the group repeated the demands of the PRC, which is no surprise as both groups were organized by the same leading figures. Again, one important item of the agenda was the promotion of a formal inflation target. When Hayami explained in a press conference on 21 August 2001 that the BOJ was clearly against the implementation of an inflation target, members of the group heavily criticised the BOJ. Another strong demand was the claim to provide the Prime Minister with the right to fire the Governor in case the BOJ does not cooperate with the government (Nakahara 2006: 87; Arita 2007; Yajima and Okada 2001; Yamamoto 2010: 168-169). Yamamoto requested the BOJ Governor Hayami to appear in a meeting of the group before the Monetary Policy Meeting on 18 September 2001 in order to discuss the group's agenda face to face (JT, 18 August 2001). Unsurprisingly, Hayami declared that the BOJ was already obliged to report its views regarding monetary policy before the Diet on a regular basis, and, therefore, firmly rejected the demand (Mainichi Shinbun, 23 August 2001).

In sum, pressure was not strong enough to urge the BOJ to implement bold monetary policy changes, but the pressure had influence on the BOJ to further ease the conditions of the quantitative easing policy. Arita (2007: 24) argues that "their activities [Diet politicians, such as Yamamoto] certainly made BOJ officials nervous". One can argue about how much influence pressure from Diet politicians actually had on the BOJ's decision to ease monetary policy in August and September 2001. Pressure from the Legislative (Diet) had contributed to the BOJ's decision to ease monetary policy. In August 2001, the BOJ increased the targeted reserves from five to six trillion Yen,[349] and, in September 2001, increased the CAB to over 6 trillion Yen. Simultaneously, the BOJ cut the ODR from 0.25 to 0.1 per cent. Pressure from legislative politicians became too strong to simply ignore, and the BOJ had no other opinion than to make some small adjustments. However, these small adjustments could be also explained as a result of the deterioration of economic conditions, and not just as the mere result of political pressure.

[349] However, at the press conference after the Monetary Policy Meeting, Hayami denied intense pressure from the group that influenced the Bank's decision (Bank of Japan 2001, Press conference 15 August 2001).

However, these small adjustments were not enough for the Yamamoto-group. Pulling their final trump card, the group decided to submit a bill to the Diet which proposed the revision of the BOJ Law. Bottom line, its aim was to weaken the independence of the BOJ in November 2001.[350] However, this bill was opposed by the Cabinet, most importantly Prime Minister Koizumi. Here, it becomes clear that the two principals – the legislative and the executive branch – followed different strategies. Prime Minister Koizumi and his Cabinet realised that public conflicts with the BOJ are very costly on a political level, and, in the worst case could destroy the confidence of the financial markets. In particular, revising the BJL again after such a short time would be detrimental to the government's credibility. Consequently, the government refrained from endorsing such a bold measure. For the Yamamoto-group, the serious attempt to re-revise the BJL was just the consequence of its efforts to obtain an easier monetary policy.

Regarding the pressure placed on the BOJ by the executive branch of the government in form of the threat to revise the BJL, it is interesting to note that the behaviour of the Prime Ministers was different. Thus, so far no Japanese Prime Minister had actively supported the BJL revision. It can be argued that Prime Ministers were aware of the political costs of conflicts between the central bank and the government, let alone a re-revision of the Bank of Japan Law. Mori repeatedly pressured the BOJ, but avoided further steps. Koizumi, although sometimes very critical towards Governor Hayami, opposed a bill to revise the BOJ Law in 2001.

As a result of the debate between the executive and legislative branches of the government, the threat to revise the BJL lost some of its danger for the BOJ. Nonetheless, the Yamamoto-group remained strong and continued to exert a high amount of pressure on the BOJ (JT, 3 November 2001; Lukauskas and Shimabukuro 2006: 144). Threats to revise BOJ Law were repeated in 2005. Especially, Nakagawa Hidenao, Chairman of the LDP's Policy Research Council (PRC) put extraordinary pressure on the BOJ. In November 2005, Nakagawa stated that "the central bank needs

[350] Ironically, Yamamoto informed Policy Board member Nakahara of the group's aim to submit a bill to revise the BOJ Law. As Nakahara was the only proponent of inflation targeting in the Policy Board, Yamamoto regarded him as an important ally in the fight for easy monetary policy (Nakahara 2006: 87).

to constantly coordinate its policy target with that of the administration. If the bank doesn't understand that, we ought to consider revising the Bank of Japan Law." However, similar to incidences in 2001, Nakagawa was not able to organize a bigger group which supported his claims, and, thus, the threat to revise the BJL remained an empty threat.

A very strong threat for an amendment of the Bank of Japan Law came from the so-called "Anti-Deflation League" (ADL, *defure dakkyaku giren*). In August 2009, the Democratic Party of Japan won the general election, and became the largest party in the Lower House. The DPJ supported central bank independence during the BJL reform process, but the attitude of the DPJ changed significantly, and many DPJ politicians became active proponents of BOJ Law revision, to minder or even destroy the BOJ's independence. In 2010, many new DPJ lawmakers established the ADL together with other influential politicians. Gradually, the ideas of the initiative also became popular in other parties, growing to a cross-party movement. The league became larger and later consisted of around 200 parliamentarians from the DPJ, LDP and smaller parties. With around 140 politicians most of the ADL's members came from the DPJ. This was more than one third of its 393 Parliament members. The ADL aggressively put pressure on the BOJ, including the demand to revise the Bank of Japan Law. In July 2010, the ADL published a report which consisted of their ideas for monetary policy, and the claim to revise the BJL. The report addressed three issues: First, the implementation of an inflation target of two per cent. Second, similar to the U.S. Federal Reserve, it suggested a maximum employment mandate (*koyô saidai ka*). Third, it claimed a new appointment procedure for the BOJ's key staff.

Next to the ADL, there was pressure on the BOJ from the oppositional Your Party (Minna no tô);[351] a small conservative party, which was founded by Watanabe Yoshimi. In November 2010, Your Party submitted a bill[352] to the Diet to revise the BOJ Law. The bill consisted of a demand to increase the role of the government in monetary policy making. However, this bill was rejected in the Diet (Dwyer 2012).

[351] Your Party was formed in 2009 and became the third largest party in the Upper House elections in July 2010.
[352] Your Party had not sufficient seats in the Lower House to bring in a bill on its own, and, as a consequence, it sought support from other parties, including the ruling DPJ.

Even if the government and politicians had not decided to revise the BOJ Law thus far, advocating and pressing towards a law revision alone could have made a difference for the Bank of Japan. For example, the BOJ may have felt forced to conduct easier monetary policy, including the increase of JGB purchases. As a consequence, although this thesis does not find that political pressure managed to change the Bank of Japan's basic monetary policy, it surely did have an effect on the central bank and its independence.

8.7.4.8 Conclusion

This subchapter showed that both the government (executive) and Diet politicians (legislative) almost constantly exerted intense pressure on the BOJ, especially on Governor Hayami. In regards of Diet hearings and government representatives in Monetary Policy Meetings, it can be argued that political pressure was increased after the revision of the Bank of Japan Law. The government exhausted every legal right it was provided with in the BJL to the fullest extent to pressure the BOJ. However, regardless of the intense pressure, the BOJ was successful in resisting political pressure most of the time, and built a remarkably independent status. It can be concluded that pressure on the BOJ worked best if both the legislative and executive branch of the government exerted pressure cooperatively. In case there was pressure only from one principal, the BOJ resisted pressure more successfully. Or, similarly, in cases in which both principals were not united, the BOJ was able to remain independent, and avoided an exaggerated easing of monetary policy. This thesis demonstrated that the efforts of a group of certain Diet politicians to re-revise the BJL again in 2001 failed to gain support from the Cabinet. The following chapter tries to explain the behaviour of the Bank of Japan in view of its monetary policy decisions and political pressure.

8.8 Explanations of the Bank of Japan's Behaviour: Independence, Risk Aversion and Structural Reforms

The case studies from the previous chapter lead to the question how monetary policy decisions of the BOJ can be explained. It is obvious that in many cases the economic condition of a nation is one basic factor that explains a central bank's choice of monetary policy. In Japan, the economic conditions were rather discouraging with deflationary tendencies as a prevailing problem since the new BOJ Law took effect in 1998. This means that the BOJ's choice of monetary policy was rather limited, and that

monetary easing policies, such as low interest rates, could not have been avoided. That is, the BOJ was not free to choose between different levels of interest rates. However, there is a certain range of discretion as to how far monetary easing could be conducted. The introduction of zero interest rates in 1999 or quantitative easing policy in 2001 did not necessarily mean that the BOJ was in support of excessive easing policies in order to support the government by all means, according to BJL, Article 4. This thesis has demonstrated that even during the quantitative easing policy period between 2001 and 2006 the BOJ did not use easing policies to the full extent to fulfil the government's demands. In contrast, Hayami and Fukui since 2005 were both reluctant to further ease monetary policy, and, therefore, actively disregarded the demands made by the government and politicians. Thus, in this section, explanations will be pieced together with the aim of understanding the BOJ's monetary policy in more detail. More precisely, two important questions remain unanswered: 1) Why did the BOJ refuse to follow the government's demand for more excessive easing policies? 2) Why was the BOJ able to overcome political pressure, and conduct independent monetary policies in many cases? This thesis finds three explanations for the BOJ's behaviour which will be elaborated in the following:[353]

1) The BOJ's fight to protect central bank independence
2) Risk aversion and blame avoidance
3) The BOJ's economic theory and the promotion of structural reforms

8.8.1 The BOJ's Fight to Protect Central Bank Independence

During his term in office, Governor Hayami invested a high amount of effort in protecting and guaranteeing the BOJ's hard-won independence from the very beginning. One measure to reach this aim was to increase the Bank's accountability and transparency. Hayami was devoted to building an independent BOJ, which would be strong enough to resist political pressure. The fight of the Hayami-led BOJ for independence as central bank helps to explain why the BOJ was reluctant to follow government's demands to ease monetary policy further in many cases. Thus, it can be argued that the BOJ's reluctance to conduct loose monetary policy has its roots in the BOJ's concern for its long-term independence. One reason for the BOJ's avoidance of excessive easing was that an increased balance sheet is connected to the risk of having

[353] For a similar view of arguments, see Lukauskas and Shimabukuro (2006: 147-151).

to increase the government's dependence on the central bank (Ide 2007; Jeanne and Svensson 2007). A government which enjoys a lot of lending from the central bank may get used to having a budget without constraint. It is difficult for a central bank to escape such a vicious circle. The BOJ wanted to demonstrate that it was independent from outside forces, and built a strategy to resist demands and threats from the government and politicians.

Thus, the BOJ's behaviour can be explained using a political economy approach. After having been granted independence, a standpoint to resist cooperation with the government or the MOF emerged within the majority of BOJ officials. BOJ officials regarded advice from the Ministry or private economists as interference in the central bank's independence (Cargill, Hutchison, and Itô 2000). After the BJL revision, the BOJ developed a new identity, and tried to build a new image of an independent agency. This argument coincides with that of Willem H. Buiter, who was an external member of the Bank of England monetary policy committee from 1997 to 2000. Buiter (2004) argues that newly operationally independent central banks tend to avoid recommendations made by the Finance Ministry. Rather, newly independent central banks are highly concerned about a loss of reputation if they do not act independently.

This observation matches the findings of this thesis in regards of the BOJ. Indeed, the BOJ almost consistently resisted many monetary policy demands from government officials and Diet politicians in order to demonstrate independence. Assuming that the government or the Finance Minister does make beneficial suggestions from time to time, the central bank's constant refusal of such proposals is not economically optimal. Rather, central bank independence can be sustained and allow cooperation with politics when the situation requires it (Buiter 2004). Similarly, Posen (2002) argues that "[t]he point of central bank independence is to be able to refuse unreasonable or politically motivated government requests – the point of independence is not to refuse any and all requests." Grimes (2003: 77-79) stated that the resistance of the Hayami-led BOJ to excessively increase quantitative easing measures can be in part interpreted as "pure bloody-minded" and a as "short-sighted assertion of its autonomy". In other words, it can be argued that the BOJ had become a prisoner of its own independence, and fell into a so-called "independence trap" (Cargill, Hutchsion and Itô 2000; Harui 2006; Kajimoto 2006; Takita 2006).

This thesis argues that an important aspect of the BOJ was Hayami's strong leadership. This aspect stresses the importance of individual leadership. Marcussen (2009: 379) argues that "[t]he history of central banking has typically been written with a particular focus on strong decisive men, who created, consolidated, and defended the integrity and autonomy of the institution." Kettl (1986: 193) also finds that the power of the US Federal Reserve had depended on its chairman to a high extent. In Japan, it turned out that the personality of the central bank's key figure, namely the Governor, is also particularly significant for the independence of the Bank of Japan.

Wilson (2000), in his attempt to explain the behaviour of government agencies in the U.S., found that the initial leader of newly founded, or altered institutions, plays a crucial role in defining the mission and future stance. That means that the best opportunity for a new organisation to achieve independence and the formulation of own goals is at the very first beginning of its creation (Wilson 2000: 188-189). Accordingly, Hayami's era as the first Governor of the newly created BOJ can be regarded as most crucial for the BOJ's future identity. Indeed, with Hayami the BOJ had a strong character, who with great effort, took the mission to protect and maintain an independent central bank even to the point of "religious overtones" (Lukauskas and Shimabukuro 2006: 147). In a book about his time as Central Bank Governor, Hayami interpreted his task to secure the BOJ's independence from governmental influence as a "calling from god" (*kami no shômei*) (Hayami 2004: iv). The new Governor stated that "the central bank must be the conscience of a country's economy" (*chûô ginkô ha ikkoku keizai no ryôshin*) (Nikkei, 21 March 1998; Fujii 2004: 53). Considering the German Bundesbank as the "ideal" central bank, Hayami was determined to protect the BOJ's independence, and to avoid serving the interests of the government, politicians, or specific interest groups (JT, 21 March 1998). For instance, regarding underwriting of JGBs, Hayami made it very clear that he was not willing to make any compromises, and stated that "[u]nderwriting cannot be an option that the BOJ adopts. Even if people hate the BOJ, we will do what we believe is right." (Arita 2007: 20). Hayami explained his motivation by revealing that he perceived himself as the "guardian of the integrity of money" (*tsûka no songen no bannin*) (Hayami 2004: iv).

It can be argued that Hayami's determination to protect the BOJ's independence seemed to be obstinate. For instance, he consistently disagreed with the majority of observers, saying that the termination of the zero interest rate policy was no mistake.[354] Unsurprisingly, some analysts and politicians argued that Hayami worked against the government and politicians out of principle.[355] Using the words of Wilson (2000: 370), one can argue that Hayami was like a zealot, and determined by "mission madness" for central bank independence. However, this critical allegory goes too far when judging Hayami. Rather, it can be argued that Hayami was determined to fill the central bank with value, namely the value of central bank independence that is most important for the BOJ's survival in the future as an independent central bank. In this sense, it is possible to say that Hayami's persistent way of protecting the BOJ's independence was very important for the Bank in the long run. Reviewing the case studies of this thesis, it is evident that Hayami successfully protected the BOJ's independence in spite of difficult conditions. He constantly absorbed intense political pressure, remained true to his ideals, and extremely rarely agreed to compromises with the government. For instance, the old tradition of the BOJ views a rate hike as a victory over the MOF and the government. Hayami "won" an intense battle against politicians by raising the interest rate in August 2000.[356] From 2001 to 2002, Hayami remained firm and avoided extreme moves to ease the amount of CAB, although Economy Minister Takenaka was frequently present in BOJ's Monetary Policy Meetings, and put intense pressure on Hayami.

Hayami's resistance of cooperation with political authorities turned out to be a miscalculation for political leaders (Pascha 2005b: 53), who paid the high price of losing a high extent of influence over monetary policy. If Hayami had bowed to political pressure easily, it would have been very difficult for the following Governors to fight back political pressure. His strong resistance against government pressure made it easier for succeeding Governors to conduct monetary policy independently. As a

[354] On his last press conference as BOJ Governor on 7 March 2003, Hayami stated that the termination of the zero interest rate policy was the appropriate choice –even when considered today. Hayami even stated that "possibly the termination was a little late" (*sukoshi osoreta kamo shirenai*) (Bank of Japan 2003, press conference 10 March 2003; Fujii 2004: 289).
[355] Interview with former MOF official, July 2008.
[356] It has to be noted that this thesis does not judge whether monetary policy decisions by the Bank of Japan were the best choice or if it proved to be wrong afterwards. Rather, the relationship between the Bank as an agent of politicians is of interest. Taking this into account, the governorship of Hayami was a success for the Bank of Japan.

result, Hayami's appointment can be considered a success for the Bank of Japan when it came to protecting its newly won independence.

8.8.2 Risk Aversion and Blame Avoidance

The second explanation of the BOJ's behaviour was the attempt of the Bank to avoid unnecessary risks. The BOJ was afraid to implement non-traditional monetary policy after having been granted independence by the government. By sticking to traditional monetary policy as much as possible, the BOJ tried to avoid risks, and being blamed in case of unexpected side effects of risky monetary policy measures. Many Policy Board members warned against toxic side effects of strong easing monetary policies, such as the reduction of interest rates, an increase in the purchase of government bonds, and an overly expanded balance sheet.[357] The BOJ was very cautious about moral hazard, and repeatedly argued that it wanted to avoid moral hazard with its policies (e.g., Bank of Japan 1999, Minutes 28 June 1999; 9 September 1999). Thus, it can be argued that BOJ's monetary policies were a strategy of blame avoidance and risk aversion. Sticking to traditional monetary policy as much as possible was regarded as the safer and better strategy to combat the deflationary tendencies in the Japanese economy. Resisting political pressure was just a logical consequence of this view.

Due to the BJL revision in 1998, central bankers were forced to enter the political field, and became political actors themselves. Before the revision, the MOF protected the BOJ from political intervention. As a consequence of the need to deal directly with politicians, the BOJ strengthened the responsibility of offices, such as the secretariat of the Policy Board, which was assigned the task of preparing Policy Board members for interaction with the government, the Diet, and the media. In addition, in order to find support for its independence, the Bank set up a strategy to enlarge its publications, research activities, and their distribution. In other words, the transparency of the BOJ was increased to a high extent. This helped the BOJ to defend its stance, and explain its monetary policy decisions to the public. In addition to detailed information of the Monetary Policy Meetings, the Bank publishes detailed data on economic and financial data, and economic research via, e.g., the IMES. As a result of the enhanced research and publication activity, the improved transparency of monetary policy decisions and

[357] See, Bank of Japan, Minutes of Monetary Policy Meetings 1998-2005.

the decision-making process allowed the BOJ actively to promote its purposes in the media; thus, it had a means to explain its policy decisions, and eventually gain public support for its policies. In regards of public lectures, during his time in office, Hayami held nearly one hundred press conferences, and repeatedly denounced the government's interference with the BOJ's monetary policy. Politicians repeatedly argued that the BOJ was to blame for the Japanese economy suffering from deflation for such a long time. In response to those critics, the BOJ employed a strategy to defend its policies, while simultaneously returning the pressure and critique to the government, e.g., by promoting structural reforms.

8.8.3 The Bank of Japan's Economic Theory and the Promotion of Structural Reforms

Some of the BOJ's policy decisions can be explained with an economics approach that critics of the BOJ considered as unusual in comparison to mainstream economic theory. In order to stress the differences, critics called the BOJ's approach the "BOJ theory" (*nichigin ryû riron*) (Fujii 2004: 23-26; Hamada 2012; Iwata 2009; Yamamoto 2010). That is, the third explanation of the BOJ's monetary policy is the promotion of structural reforms *(kôzô kaikaku)* of the Japanese economy.

One main representative of the BOJ-theory was Okina Kunio, who entered the BOJ in 1974, and was Director of the Institute for Monetary and Economic Studies (IMES, *Nippon ginkô kinyû kenkyû jo*), the BOJ's research institute, from 1998 to 2006. Apart from Okina, the Bank of Japan's view was also represented by other staff from the IMES and some of these economists fiercely defended the monetary policies of the Bank of Japan. Some publications emphasized the risks and side effects that could have affected the central bank in case of zero interest rates and aggressive monetary easing (e.g., Fujiki, Okina and Shiratsuka 2001; Fukao 2006; Oda and Okina 2001; Shirakawa 2001; Shiratsuka 2010). Papers by IMES staff had influence on the content of speeches and press conferences given by the Governors, Deputy Governors, and other Policy Board members.

One of the BOJ's and Okina's main rivals was Iwata Kikuo, Professor of economics at Gakushûin University.[358] The disputes between the two were known as "Okina theory" (Okina riron) versus "Iwata theory" (Iwata riron), or the "Iwata-Okina controversy" (Iwata-Okina ronsô) (Fujii 2004: 23-24, 58). One example of disputes between the two was about the causality between money stock and aggregate demand (see, Okina 1993 and Iwata 1993). Hamada and Noguchi (2005) commented the heated discussion with the following statement, taking the position of BOJ critics:

> "During this critical period of the early 1990s, there was a sharp division of opinions between the BOJ economists represented by Kunio Okina and some other economists, notably Kikuo Iwata, Seiji Shinpo, Takahiro Miyao, and Yutaka Harada, who criticized the BOJ's sluggish move toward monetary easing. In retrospect, those who criticized the BOJ seemed to have had far more valid points."

The BOJ and private economists, including foreign economists, evaluated the economic condition and the appropriate monetary policy differently. For instance, papers by Jinushi, Kuroki, and Miyao (2000), Ahearne et al. (2002), and McCallum (2001) state that the BOJ's unwillingness to ease monetary policy from 1993 to 1994 was the ultimate reason for Japan's deflation and prolonged recession. Numerous other studies recommended bolder action by the BOJ, e.g., buying assets other than short-term bills or to announce targets for the inflation rate or price level (e.g., Cargill and Guerrero 2007; Goodfriend 2001: Krugman 1998; Meltzer 1999a; 1999b; Svensson 2000; Taylor 2001). The BOJ was also criticised by Japanese scholars. Besides Iwata Kikuo and Harada Kôichi, the Director of the ESRI Institute, Japanese economists who argued critically against the BOJ included Yoshikawa Hiroshi, Itô Takatoshi, and Noguchi Asahi.

Regardless of the critique, BOJ officials continued to promote their views of economics and monetary policy, for instance regarding zero interest rates and quantitative easing policy. Until the implementation of quantitative easing policy in March 2001, the BOJ constantly declared that excessive quantitative easing had absolutely no effect (*dôse kikanai*) on the economy (Fujii 2004: 116; 232). Rather, BOJ economists pointed out negative side effects of strong monetary expansion (see, for instance, Okina 1999 and Oda and Okina 2001). Similarly, regarding the introduction of an inflation target, the

[358] It is noteworthy that Iwata Kikuo is one of the BOJ's Deputy Governors since 2013.

BOJ was in opposition, and argued that inflation targeting is ineffective and is even damaging to the economy. In sum, the BOJ's responses to their critics can be summarised as follows:

1. Policy measures such as inflation targeting and stronger easing do not help to boost the economy
2. There is no necessity to implement stronger easing policies and the economy will recover by itself
3. Stronger easing monetary policies are risky, and dangerous long-term consequences may occur

One key subject was the debate about deflation, which some economists divided between good deflation (*yoi defure ron* or *yoi bukka geraku ron*) and bad deflation (*warui defure ron*).[359] [360] Since 1999, Japan has experienced deflation that is unprecedented in other developed countries. However, the necessity of overcoming the deflation problem was viewed differently in Japan. In particular in the early stage of the recession, the Japanese media tended to view deflation as a positive phenomenon (good deflation).[361] This perception of good deflation was well postulated in the BOJ (e.g., Fujii 2004: 123; 147-148).[362] Policy Board member Miki (2000) welcomed the deflationary tendencies in the Japanese economy as good deflation in a speech he gave on 20 April 2000. BOJ officials argued that deflation pressures had its origin in technological change, and the increasing import of cheap products from low-wage countries, most notably China (Itô 2004; Miyagawa et al. 2008: 47). Gyôten (2003: 3) generalizes the argument that not only the BOJ, but also the government and academics were reluctant to fight deflation:

> "It was an intriguing phenomenon that in spite of the forceful academic arguments and also the evidence of a progressing deflation there was no broad consensus in Japan to support bold anti-deflationary measures.

[359] For a general discussion of the historical perspective of good versus bad deflation, see see Bordo et al. (2004) and Bordo and Filardo (2005). For Japan, a good summary can be found in Saxonhouse (2005).
[360] Hamada and Noguchi (2005) distinguish the good deflation theory into following four aspects: 1. Deflation is a good phenomenon; 2. Deflation is not a monetary phenomenon but a structural, that is, microeconomic phenomenon; 3. The causes of current deflation are globalization, deregulation, and technological innovation; 4. The depreciation of the Yen harms both Japan and the rest of the world.
[361] Genda (2011) refers to the term "Uniqlo phenomenon" that lower prices have often been welcomed by the general public.
[362] See, e.g., an interview with Murayama Shôsaku, Head of BOJ statistics department (Nikkei, 7 February 2001).

> Government, the central bank, political parties, the mainstream academia and the business were all sceptical about the effectiveness of drastic anti-deflationary policies."

Critics of the BOJ argued that the BOJ's attitude towards deflation may have increased the deflationary tendencies in the Japanese economy.[363] In several official documents, the BOJ warned against high risks of quantitative easing policy, above all future inflation. The fear of inflation helps to explain why the BOJ was reluctant to introduce strong easing monetary policies. Instead, a number of top level BOJ officials supported the idea of long-term structural reform, rather than offering short-term measures of monetary easing to help the economy to recover (Pascha 2005a: 15-17; Posen 2000). The Bank of Japan "has continually argued that the economy cannot recover without restructuring and has worried that expansionary monetary policy was seen as an alternative to the needed restructuring and thus may be counterproductive" (Itô and Mishkin 2004). The claim to promote structural reforms can be found in various speeches and lectures by BOJ officials, and is also recorded in official BOJ documents (e.g. Bank of Japan, Monetary Policy Meeting, 8 March 2000, 24 March 2000; Hayami 2000, Hayami 2004: 189-199; Shirakawa 2001).

Various Policy Board members argued in favour of structural reforms in the Monetary Policy Meetings soon after the new BOJ Law took effect. [364] For instance, Taketomi Susumu, Policy Board member from 1997 to 2001, stated in a speech on 31 May 1999 that "the Japanese economy will not recover until the problems of structural reforms will be solved." The BOJ`s approach to structural reforms included a growing efficiency of government spending and a more flexible employment system. In the February 2001 Monetary Policy Meeting, some members raised the issue of structural reform, and demanded a more detailed discussion. In the end, the Policy Board stressed the role of the government, but regarded its own role to encourage structural reform in various sectors, for instance regarding nonperforming loans.

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[363] Regardless of the discussion between good and bad deflation, a recent BOJ study by Nishizaki, Sekine and Ueno (2012) offer a deep analysis of the phenomenon of prolonged period of deflation and its structural features in Japan. They list hypotheses but conclude that it is too early to find a dominant explanation for the chronic deflation in Japan.

[364] Freedman (2006: 52) argues that even before the new Law took effect the BOJ`s monetary policy "seemed determined to push their agenda of structural reform without regard of the short term economic fall out". However, this thesis focuses on the new BJL.

> ”Members also discussed the necessity of structural reform. Some members pointed out that even if the Bank, as the central bank, adopted necessary measures, this alone would not solve the fundamental problems of the Japanese economy. They stressed that structural reform in the financial system as well as in the economy and industry was essential to ensure a sustainable economic recovery. […] First, structural reform should be undertaken by the private sector itself according to market principles. Second, the role of the Government was to create the environment for such structural reform and to provide a clear picture of the future economy. And third, with regard to fiscal policy, quality, not quantity, of fiscal spending was important. These members said that the *Bank should encourage various sectors to further accelerate structural reform* by, for example, solving financial system problems through the disposal of nonperforming loans.” (Bank of Japan 2001, MPM on 28 February 2001; italics added)

This quote demonstrates that the Policy Board assumed an active role in the promotion of structural reforms, at least in certain areas. However, the main role was still reserved for the government. Owing the fact that the BOJ viewed monetary policy as insufficient to solve the problem, the BOJ regarded itself in a position to promote structural reforms. In addition, with the promotion of structural reforms, the BOJ could send back pressure to the government. Since the introduction of the quantitative easing policy in March 2001, the BOJ repeatedly stated that it had done all it could and claimed that it was now the government’s turn (*kondo koso seifu no ban*) to overcome the sluggish economy and deflation pressures through structural reforms (Fujii 2004: 274-278).

The BOJ’s third Governor Shirakawa also requested the government promote structural reform on various occasions, and repeatedly argued against extensive monetary easing. The following quote shows that Shirakawa tried to resist political pressure for monetary easing by putting pressure on the government to do more for structural reform. In one occasion, he provided an international political economy reasoning:

> “Shirakawa warned that enhanced monetary easing in developed countries could create a bubble in emerging economies by triggering a shift in capital flows. Structural reform is indispensable, Shirakawa suggesting that the reform can help boost productivity growth. The move came as the government and both ruling and opposition lawmakers exerted pressure on the central bank to do more in fighting the country's persistent deflation and the impact of the recent sharp rise of the Yen, which has adversely impacted Japan's export-led recovery.” [sic] (JT, 12 October 2010).

Another interpretation suggests that the BOJ avoided more drastic easing policies in order to force the government into action towards structural reforms. This strategy implies that the BOJ deliberately chose a monetary policy that accepted painful side effects, such as a sluggish economy in order to promote long-term structural reforms. In this case, a deteriorated economy can even support the central bank's strategy. A weakening economy obliges lawmakers to enforce structural reforms without hesitation. Easy monetary policy would give lawmakers the incentive to suspend necessary structural reforms, because of the positive short-term effects of easy money to boost the economy. In contrast to that strategy, the BOJ, having considered the limits of monetary policy, selected a broader and long-term approach for improving the economy. The BOJ's plan was to force lawmakers to build an environment that secures long-term growth of the Japanese economy. Economic historians call this strategy "liquidationism",[365] or creative destruction[366] (Lukauskas and Shimabukuro 2006: 142-143; Hamada and Noguchi 2005). Applying this approach of "liquidationism" to the BOJ means that the Japanese central bank (in its position as agent of the government) misinterpreted its role with the promotion of structural reforms. In fact, structural reforms are not mentioned in the BJL, and, therefore, do not belong to the duties of the BOJ. Although structural reforms seemed necessary in Japan, a central bank should never use the promotion of reforms in order to avoid proper policies against deflation (Hamada 2004: 229-230). If structural reforms were a serious attempt of the BOJ to achieve long-term economic development, then Rogoff's (1985) concept of a central bank as a benevolent social planner is applicable to the BOJ. The BOJ took on a new role, and showed that it cared about the development of the Japanese economy beyond the mere scope of monetary policy and the maintenance of price stability.

When applying the principal-agent theory, it can be argued that the agent (BOJ) acted too independently and antagonistic towards the government. Such behaviour is a kind of agency shirking or agency slippage as a type of non-cooperation by the agent, and can lead to agency losses (McNamara 2002: 55-56; Elgie 2002; Pollack 1997: 108-110;

[365] For a "liquidationist" view of the Federal Reserve's response to the Great Depression between 1929 and 1933, see De Long (1990) and Eichengreen (2002). For a broader application of this approach, see Caballero and Hammour (1999).

[366] Many economists argued that too many weak companies had survived the bubble economy. The BOJ avoided extreme monetary easing, which would help weak companies and banks continuing to survive. In contrast, if only the strong companies survive, a healthier economic environment is emerging (Pascha 2005a: 15-16).

Kassim and Menon 2003: 122-124). This means that the agent does not follow the principal's goals. In a principal-agent framework, this is the problem of adverse selection (McNamara 2002: 55). That means that the principal (government) has chosen an agent (BOJ) with different policy preferences, which conducted monetary policies that are at odds with the goals of the principals. Following this line of reasoning, the government's right to choose the Central Bank Governor can lead to the conclusion that principals might be able to limit agency shirking or slippage by the agent (Gilardi 2001: 12). However, governments certainly cannot avoid (ex post) moral hazard by Central Bank Governors, even if the Cabinet tries to influence the Governor's behaviour before and after the appointment. In the case of Hayami, the government was shocked to see the Governor acting so differently from what they had expected. In the government's opinion, the behaviour of the Hayami-led BOJ was classifiable as moral hazard. From the perspective of the Bank of Japan, it can be argued that Hayami simply tried to protect the BOJ's independence. In practice, the BOJ acted more independent than many LDP lawmakers intended, which resulted in a loss of power over the BOJ.

Shirakawa commented a Cargill paper (2001: 141-142), and noted that the BOJ's monetary policy, such as the zero interest rate policy and the quantitative easing policy might not have been necessary if the government had conducted adequate structural policies, in particular regarding the nonperforming-loan problem. Shirakawa characterises the BOJ's monetary policy as "responsibility without authority",[367] which means that the BOJ had to take responsibility for structural problems such as the non-performing loans problem and the deflationary tendencies in the Japanese economy without having the authority over measures to solve these problems.

In addition, there are further approaches that can be used to understand the rationale behind the conduct of monetary policy by the BOJ. One can argue that cultural aspects play an important role when attempting to explain the behaviour of the Bank of Japan. One example is the relationship to the Ministry of Finance (Ide 2007). Being tied to and controlled by the MOF for such a long time, the BOJ was longing to end this close

[367] With the term "responsibility without authority" Shirakawa referred to Marvin Goodfriend. Goodfriend argued that it is quite difficult for a central bank "to play a proactive role in issues over which it is not given authority but only responsibility". As a consequence, a clear arrangement between the government and the central bank is needed in order to secure the reliability of decision-making on monetary policy (Cargill 2001: 141).

relationship, and become an independent agency. Once it was independent in a de iure sense, the BOJ acted independently and implemented independent monetary policy. Moreover, it reacted with a combination of strong resistance and tactical cleverness against too much interference of the government and politicians. Posen (2000) stresses the importance of cultural aspects, and the role of ideas in explaining the BOJ's monetary policy.

> "Explaining why the BOJ has been able to sustain its self-appointment as 'enforcer' is a matter of political science, not even political economy […] neither benevolent welfare optimisation nor institutional design is sufficient to explain policy choices by central banks. *Ideas, even economically misguide ones, also play a role*" (Posen 2000: 207; italics added)

These kinds of ideas include the promotion of structural reforms, the view of "good deflation", or the view that monetary policy is ineffective in a deflationary environment. Various sources assume that the central bank has taken its own approach to macroeconomic theory, which is somewhat different to mainstream textbook macroeconomics (Iwata 2009; Hamada and Noguchi 2005).

8.9 Conclusion

Regarding the subject of appointment, this thesis showed that two Governors out of three (Hayami and Shirakawa) were appointed BOJ Governor by default. The selection of the third one, Fukui, was a natural choice, but not necessarily the government's first choice. In all three cases, the government had hoped to appoint a Governor with whom it would be possible to implement a mutually harmonious economic policy. After analysing the appointment procedure of the three Governors, it can be argued that up until now, the appointment procedure under the revised BOJ Law from 1998 works in favour of the BOJ, in comparison to the old BJL, in which Governors switched alternately from the BOJ and MOF. According to the new BJL, the Governor cannot be dismissed by the government, and, thus, a BOJ Governor can act much more independently than under the old BOJ Law. The appointment procedure of the Governor, the two Deputy Governors, and the deliberative members of the Policy Board requires the approval of both houses of the Diet. In sum, the selected BOJ Governors were compromise candidates, and all of them were former officials of the BOJ.

The section about monetary policy demonstrated that the government put intense pressure on the BOJ right after the BOJ was granted independence. This thesis demonstrated that the government still possesses strong tools to exert pressure on the BOJ, including the right sending two government representatives to Monetary Policy Meetings (Article 19), or the right to demand the Governor to appear before the Diet (Article 54, Paragraph 3). In addition, some supplementary measures, such as sending incumbent Cabinet Ministers, sending more than two representatives, who change alternately, or giving remarks at the beginning of the Monetary Policy Meeting, are used by the government to give their standpoint more strength.

This thesis, therefore, concludes that the assumption that central bank independence eases the conflict over monetary policy (Goodman 1991) is not supported by the Bank of Japan case study. The change in the institutional design of the BOJ in 1998 towards a more independent central bank did not change the situation fundamentally for the better. Rather, political pressure strengthened after the implementation of the BOJ Law reform. Conflicts between the government and Diet politicians with the BOJ increased, in particular under the leadership of Governor Hayami. Thus, the conclusion of this thesis is that monetary policy in Japan is very much politicised.

During Hayami's period in office, the BOJ focused on independence and accountability. Hayami successfully resisted strong pressure from the government and politicians. Reviewing the case studies of this thesis, one can argue that Hayami successfully protected the BOJ's independence under difficult circumstances. He constantly absorbed intense political pressure, stuck to his ideals and extremely rarely agreed to compromises with the government. For instance, Hayami successfully resisted political pressure, and implemented the termination of the zero interest rate policy in August 2000. When Fukui took the helm of the BOJ in 2003, it was a time of major policy change, as Fukui was willing to adopt more easing and unorthodox monetary policies. In the beginning of the leadership of Fukui, there was a good relationship between the BOJ and the government and politicians. However, in 2006 Fukui stopped of being cooperative to the government, and terminated the quantitative easing policy in 2006, and raised the interest rate in 2007.

It is most intriguing that the Japanese government or politicians rarely gave statements which aim to protect the independence of the BOJ after the law revision. In order for central bank independence to be perceived as credible among the public, political support is an important prerequisite. Without political support, it is difficult to achieve institutional independence. In Japan, it was rather the case that the government constantly used the BOJ as a scapegoat to deflect from its own policy mistakes. Thus, this thesis argues that Japanese politicians never intended to have a de facto independent BOJ. In fact, the BOJ turned out to be very different from the central bank envisioned by the majority of Japanese politicians. Moreover, the BOJ has developed into a significantly more independent and powerful actor than would have been predicted by most observers.

This thesis concludes that the BOJ was successful in resisting political pressure most of the time. The case studies demonstrated that the behaviour of the BOJ can be explained by three factors, namely the BOJ's determination to gain central bank independence, its attempt to avoid being blamed, and the promotion of structural reforms.

In a theoretical framework with two principals, the agent needs to "satisfy" only one principal. In other words, the agent has low-powered incentives to follow the principal`s goals (Dixit 1996). Indeed, the executive and legislative branch of the government did not follow the same goals all the time. For example, threats made by the legislative in 2001 to revise the BOJ Law in order to cut off the Bank's independence were not supported by the government. The existence of multiple principals made it arguably easier for the Bank of Japan to follow its own policy goals such as the promotion of structural reforms. However, if both principals united their power, political pressure had a higher probability of success. For instance, when the legislative and executive combined their claim for easier monetary policy on 14 August 2001, it was difficult for the BOJ to resist.

One conclusion of the BOJ case studies is that central bank independence is a continuous and not a dichotomous variable (independent vs. dependent), meaning that there are various levels of central bank independence (Eijffinger and Hoeberichts 2000; Gilardi 2001; Goodman 2001). When key acting figures change, the monetary policies and the relationship between the central bank and politicians change as well. Although

the legal framework of the BOJ (the central bank's statute) was consistent, the case studies of this chapter demonstrated that the BOJ's de facto independence fluctuated over time.

9. CONCLUSION

The main goal of this thesis was to empirically investigate why the Bank of Japan Law was revised in 1998, and how the BOJ's institutional status regarding central bank independence and monetary policy has been affected. This thesis focused on both the de iure and de facto independence of the Bank of Japan. The new Bank of Japan Law of 1998 was the basic source for the analysis of the de iure central bank independence. Regarding de facto central bank independence, this dissertation set two foci: the appointment procedure of the BOJ's key staff, and monetary policy decisions. In particular, as described in the introduction, this study attempted to answer the following research questions:

1. What were the motivations of Japanese lawmakers to change the central bank law and to delegate independence to the Bank of Japan?
2. What were the changes in the new Bank of Japan Law, and how did these changes affect central bank independence? (de iure analysis)
3. How did the Bank of Japan's independence change regarding the appointment procedure and monetary policy, and how did the BOJ react to pressure imposed by the government and politicians? (de facto analysis)

In order to find answers to these questions, various types of sources were used in a two-method approach. For instance, many primary sources, such as official Bank of Japan documents, were employed. One crucial contribution in this study is the application of many original sources in Japanese, and the completion of 23 expert interviews, including interviews with Bank of Japan and Ministry of Finance officials. In the following section, final conclusions are drawn for each single chapter.

Chapter 1 introduced and **Chapter 2** provided the theoretical framework for the analysis and interpretation of the Bank of Japan's independence in the subsequent chapters. This thesis is an in-depth case study of the Bank of Japan. The methodology used in this dissertation was two-fold. A principal-agent framework was combined with a historical institutionalism approach in order to examine the institutional design and independence of the Bank of Japan. This thesis analysed the delegation to an independent Bank of Japan, the de facto appointment procedure, and monetary policy decisions made by the BOJ by employing principal-agent theory with multiple principals. Both the executive (Government/Cabinet) and the legislative (Diet

politicians) branches of the government were identified as principals which exert influence on the agent, the Bank of Japan.

Chapter 3 concentrated on the reform process of the Bank of Japan. Before the revision of the Bank of Japan took place in 1998, former attempts in the 1950s and 1960s failed. Finally in 1996, the Hashimoto government put central bank reform on the agenda. Only two years later, a new Bank of Japan Law came into effect. However, the process of the BJL reform, and the result were criticised. Most importantly, the speed of the reform process, and that the very same people and the MOF were responsible for the process and the contents of the new law were identified as the main points of critique. The high influence of the Ministry of Finance concerning the contents of the BJL was clearly visible. Important in this chapter is the role of various actors in the reform process. This thesis found that the leading party, the LDP, was not really interested in central bank reform and independence, but primarily aimed at reducing the power of the Ministry of Finance.

Chapter 4 reviewed the existing literature on the delegation to an independent central bank, and tested the most relevant theories on the Bank of Japan. It demonstrated that central bank reform in Japan cannot be explained by a single delegation theory, but rather has multifaceted reasons. In Japan's case, most of the "common" delegation hypotheses do not work. Rather, this thesis attributed the motive to decidedly political factors. Extraordinary political events and bureaucratic scandals led to high uncertainty among the electorate. The collapse of the LDP hegemony in 1993 is regarded as a landmark event that led to a changing relationship between the LDP and MOF. This was an important factor for financial reform, including the revision of the Bank of Japan Law. The examination of the Bank of Japan Law revision process demonstrated that political factors had indeed played a key role. The most important motive for the ruling parties in the Hashimoto Cabinet to support reform was the struggle for political survival, namely their attempt to remain in power for the forthcoming election.

This chapter dealt with the strategy of blame avoidance, which explained how political key actors were able to shift the blame for the deteriorating Japanese economy to the MOF. Finding a scapegoat in the MOF resulted in reforms and changes in the Ministry, including the revision of the Bank of Japan Law in 1998. The central bank reform was

embedded in a greater reform of the MOF. Political actors used the Ministry as a scapegoat, and basically tried to protect themselves against political distress, while simultaneously trying to increase their re-election prospects. As a result, the independence of the new Bank of Japan was not something the BOJ had successfully fought for and won, but rather BJL reform came by default, arriving as a consequence of the failures and scandals in the Ministry of Finance.

Chapter 5 showed that the Bank of Japan Law revision of 1998 improved the BOJ's legal independence significantly, and provided the Bank with operational independence to pursue its objectives. However, regardless of some essential improvements concerning central bank independence, the principal finding of this chapter is that the overall result of the new law was unsatisfactory. Some important articles of the Bank of Japan Law are deficient, and have ambiguous formulations in both the Japanese and English versions. For instance, the new Bank of Japan Law provided the BOJ with multiple objectives – price stability and the maintenance of an orderly financial system. Other articles, especially Articles 4 (relationship with the government) and 19 (attendance of government representatives) are critical to central bank independence, and might be an obstruction to the proper conduct of monetary policy. In addition, regarding a central bank's financial independence, the Bank of Japan continues to lag behind other major central banks.

Another important issue of this chapter were central bank independence indices. The result from the analysis of the 1998 BJL was confirmed, and the BOJ improved its score of independence for most major central bank indices in comparison to before the law revision (e.g., the Cukierman, Webb, and Neyapti Index). In the last part of this chapter, the index by Laurens et al. (2009) was updated, and verified that the political independence of the BOJ is higher than suggested in the original index. The overall conclusion of this chapter is that the BOJ's de iure independence increased with the BJL revision, but still remains lower than that of other major central banks, such as the European Central Bank, the US Federal Reserve, and the Bank of England.

Chapter 6 demonstrated that the Bank of Japan has increased its accountability and transparency by a substantial amount owing to the new BJL. Regarding central bank accountability, the BOJ publishes minutes of its Monetary Policy Board Meetings, and

submits a report to the Diet on a semi-annually basis. Upon request, the Governor or a representative has to testify before the Diet. It is crucial to distinguish between transparency to the public, to the government, and to the Diet. In all three aspects the BOJ's transparency was enhanced.

As a result of these changes, the BOJ gained higher values in leading central bank accountability and transparency indices. This view was confirmed by an update of the central bank accountability index by Laurens et al. (2009) and the central bank transparency index by Eijffinger and Geraats (2006). However, the assessment of the BOJ's transparency and accountability in indices depended on the structure of the index. Generally speaking, the BOJ scored well if an index concentrates on publications of minutes and the voting structure, or the disclosure of information. In contrast, if the indices focused on the prioritisation of objectives of monetary policy, the BOJ scored relatively poor. A second conclusion of this chapter was that the transparency of the Bank of Japan has increased to a remarkable extent over time; especially since 2000, the year when Policy Board members started to publish projections of the economy, and 2007, when the BOJ started to publish individual voting records of its Policy Board Meetings. These findings were confirmed by means of updates of the central bank transparency indices by Dincer and Eichengreen (2010) and Minegishi and Cournede (2009).

Chapter 7 demonstrated that a simple distinction between dependent and independent central banks is insufficient when attempting to understand central banking in Japan. The political and economic system in Japan is characterized by peculiar features. First, it was characterised by a remarkable political stability after the Second World War; a stability that was based on the LDP's commitment to seek rapid economic growth. Second, the bureaucratic decision-making in the Bank of Japan is too complex to be explained by a simple dependent-independent Anglo-Saxon framework. As a result, this chapter offered an analysis of the de facto environment of the Bank of Japan's independence by concentrating on the old Bank of Japan. This chapter demonstrated that the old Bank of Japan was characterized by a system of alternating Governors and Deputy Governors, meaning a Governor from the BOJ was always replaced by a Governor from the MOF, and vice versa. The Deputy Governor was always from the other organisation, and became the following Governor. Another finding of the chapter

is the fact that the MOF acted as safeguard for the BOJ from time to time, protecting the central bank from politicians' pressure, but increasing the BOJ`s dependence on the MOF. Regardless of these limitations of central bank independence, it was shown that the BOJ was able to gain a remarkable amount of de facto independence.

Chapter 8 presented an in-depth analysis of the Bank of Japan concerning both the appointment process of the central bank's key staff and monetary policy decision-making. Regarding appointments, it was shown that the Japanese government tried to appoint Governors and Deputy Governors who share similar stances on monetary policy, or persons who were viewed as easy to influence. As a result, appointments of BOJ Board members became highly politicised after the implementation of the new Bank of Japan Law.

The same result was found with regards to monetary policy. A high amount of political pressure on the BOJ emerged after the law revision. This thesis divided political pressure between two principals, the executive and the legislative branch of the government. Both principals, the government and Diet politicians, did their utmost effort to force the Bank of Japan to cooperate with the aim to overcome the deflationary problem of the Japanese economy. The Bank of Japan was unwilling to follow the government and politicians' wishes, and preferred to protect its independence by conducting independent monetary policy as much as possible. This behaviour resulted in many conflicts with the government and politicians. Consequently, this thesis argued that monetary policy under the new BOJ Law was highly politicised regardless of the BOJ's de iure independence. One important channel of pressure was the threat to re-revise the BJL, and to make the BOJ dependent on the government again. These threats were formulated by certain Diet politicians and the Anti-Deflation League. The government did not support this movement, and, as a result, the BOJ Law is still intact.

In sum, this thesis showed that the BOJ turned out to be extremely different from the central bank envisioned by the majority of Japanese politicians. The BOJ has developed into a significantly more independent and powerful actor than would have been predicted by most observers. One important conclusion is that the relationship between the BOJ and the government is determined by social, economic, political and historical contexts rather than by legal contexts. More precisely, this thesis' conclusion is that the

BOJ was able to gain a fair amount of de facto independence. That is, the de iure status of the BJL is not so important in Japan. Instead, informal institutions shaped, and continue to shape the extent of de facto independence of the Bank of Japan.

Recent Developments and Future Implications

This thesis focused on the period between 1996 and 2012, and argued that the BOJ was successful in protecting its central bank independence after the BJL revision. However, where the BOJ is heading is entirely unclear, and is an interesting question for future studies.

Based on the findings in this dissertation, it is possible to argue that it is promising that the BOJ will enjoy full independence as an organisation in the long-run. From this perspective, politicians will find it difficult to change the central bank law again, because of the political high costs. Although threats to cut off the BOJ's independence have a certain impact on the BOJ, a realisation is most difficult, because a change in the BOJ's legislation requires a high extent of agreement between political actors. In a de facto sense, the BOJ has shown that it was able to conduct independent monetary policy until 2012.

Regardless of these considerations, there is a global trend regarding a changing stance of central banks. Since the global financial crisis, an urgent need to revive and sustain economic growth, and to avoid financial collapse in many countries worldwide exists. In response to financial crises, many central banks, most prominently the US Federal Reserve, the European Central Bank, and the Bank of England, conducted very aggressive monetary policies, and adopted very low interest rates. Quantitative easing became the norm. A development towards greater economic uncertainty led to situations demanding changes in the tasks of central banks. Discussions concerning whether a high amount of central bank independence is still the preferable institutional set-up in these times of large economic shocks were initiated.

Japan is no exception to this trend. In 2012, Abe Shinzô became Prime Minister, and introduced the so-called "Abenomics". This economic policy programme aims at reviving the Japanese economy, and overcoming deflation. Besides fiscal policy and structural reforms, monetary policy is a central component. The Abe administration

believes that the Bank of Japan should print much more money, and should purchase a higher amount of Japanese government bonds. That is, the government expects the Bank of Japan to support the Cabinet's effort to help the Japanese economy out of the deflation. This is nothing new for the Bank of Japan, as was demonstrated in this dissertation. However, Abe is much more determined than his predecessors. One indicator is that Shirakawa, who never really bowed to government's wishes, and, therefore, was strongly criticised by Abe and Finance Minister Asô, resigned before his official term ended. It can be doubted whether the official statement that Shirakawa did not want to disturb the implementation of a new Governor and two Deputy Governors, is the only reason behind Shirakawa's resignation.

After Shirakawa's resignation, Abe appointed Kuroda Haruhiko as the new Governor of the Bank of Japan. Kuroda, a former president of the Asian Development Bank, is known as a person who supports quantitative easing, and the introduction of an inflation target. In addition to Kuroda, Iwata Kikuo and Nakasô Hiroshi were appointed Deputy Governors. The appointment of Iwata is especially critcal, because he has been a constant and harsh opponent of the BOJ's monetary policies throughout his academic career.

Soon after Kuroda came into office, the BOJ introduced the "Quantitative and Qualitative Monetary Easing" framework. This new policy framework consists of the introduction of a price stability target of 2 per cent. The BOJ aims at reaching this target in about two years. The Bank decided to increase the monetary base, so as to reach 270 trillion Yen in two years. This means that the monetary base will be doubled until the end of 2014. In comparison to other major central banks, such as the US Federal Reserve, or the Bank of England, this was a very strong measure. In order to achieve this target, the BOJ planned to extraordinarily increase its holdings of Japanese government bonds. It is interesting to note that the fashion towards inflation-targeting decreased in response of the financial crisis, and central banks were obliged by governments to keep their hands off inflation targeting. Instead, they were to remain in a flexible position, in order to support the national economy with bold monetary stimulus. It is intriguing that Japan introduced an inflation targeting framework at a point in time when the efficiency of this tool was doubted.

With the appointment of Kuroda and the introduction of the new policy framework, the debate concerning the BOJ's independence continues. With the implementation of a Governor and a Deputy Governor who are very close to the government, the BOJ's independence is in danger. It seems that with the introduction of "Quantitative and Qualitative Monetary Easing" and a price stability target the BOJ might have violated "holy principles" made by former Governors Hayami, Fukui, and Shirakawa. It is clear that the current developments are an infringement to central bank independence, for which the BOJ had strongly fought for. If the government decides to undermine the BOJ's independence permanently, long-term harm cannot be ruled out. However, it is too early to judge whether or not the current changes are temporary, or if they will have stronger effects on the Bank of Japan's independence in the future. In case "Abenomics" turns out to be a success, demands to protect the Bank of Japan's independence will probably fade away, and become obsolete.

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APPENDICES

Appendix A:

Construction and Coding of the Cukierman, Webb, and Neyapti (1992) Central Bank Independence Index

1. Governor/CEO (Weight in overall index = 20%)

a) Length of term in office (weighted 25%)
More than 8 years 1.00
6 to 8 years 0.75
5 years 0.50
4 years 0.25
Less than 4 years or at discretion of appointer 0.00

b) Who appoints? (weighted 25%)
CB Board 1.00
CB board, executive branch, legislative branch jointly 0.75
Parliament or legislative branch 0.50
Executive branch 0.25
One or two members of executive branch 0.00

c) Dismissal (weighted 25%)
No provision 1.00
Possible only for reasons not related to policy 0.83
At the discretion of the CB board 0.67
At the discretion of the parliament or legislature 0.50
Unconditional dismissal at discretion of parliament or legislature 0.33
At the discretion of the executive 0.17
Unconditional dismissal at discretion of the executive 0.00

d) May CEO hold other offices in government simultaneously? (weighted 25%)
No 1.00
Only with permission of executive branch 0.50
No rule against holding another office 0.00

2. Policy formulation (Weight in overall index = 15%)

a) Who formulates monetary policy? (weighted 25%)
CB alone 1.00
CB participates but has little influence 0.67
CB advises government 0.33
CB has no say 0.00

b) Who has final word in resolution of conflict? (weighted 50%)
CB on issues clearly defined in the law as its objectives 1.00
Government on policy issues not clearly defined as CB goals

or in case of conflict within CB 0.80
CB board, executive branch, legislative branch jointly 0.60
Legislature or parliament on policy issues 0.40
Executive branch on policy issues, subject to due process and possible CB protest 0.20
Executive branch 0.00

c) Role in government budgetary process (weighted 25%)
CB active 1.00
CB has no influence 0.00

3. Policy objective (Weight in overall index = 15%)

Price stability is the major or only objective, and CB has final word in event of conflict
with other government objectives 1.00
Price stability is the only objective 0.80
Price stability is one objective among multiple compatible objectives 0.60
Price stability is one objective among multiple, potentially conflicting, objectives 0.40
No objectives stated 0.20
Stated objectives do not include price stability 0.00

4. Lending to government (Weight in overall index = 50%)

a) Advances (weighted 15%)
No advances 1.00
Permitted, with strict limits 0.67
Permitted, with loose limits 0.33
No legal limits on lending 0.00

b) Securitized lending (weighted 10%)
Not permitted 1.00
Permitted, with strict limits 0.67
Permitted, with loose limits 0.33
No legal limits on lending 0.00

c) Terms of lending (weighted 10%)
Controlled by CB 1.00
Specified in CB law 0.67
Agreed between CB and executive branch 0.33
Decided by executive branch alone 0.00

d) Potential borrowers from CB (weighted 5%)
Only the central government 1.00
All levels of government 0.67
All levels of government plus public enterprises 0.33
Public and private sector 0.00

e) Limits on CB lending defined in (weighted 2.5%)
Specific currency amounts 1.00
Shares of CB demand liabilities or capital 0.67
Shares of government revenue 0.33
Shares of government expenditures 0.00

f) Maturity of loans (weighted 2.5%)
Within 6 months 1.00
Within 1 year 0.67
More than 1 year 0.33
CB law does not specify maturity 0.00

g) Interest rate of loans must be (weighted 2.5%)
Above minimum rates 1.00
At market rates 0.75
Below maximum rates 0.50
Interest rate not mentioned in law 0.25
No interest charged on government borrowing from CB 0.00

h) CB prohibited from buying/selling government securities in primary market? (weighted 2.5%)
Yes 1.00
No 0.00

Appendix B:

The Laurens et al. (2009) Central Bank Accountability Index

Responsibility: maximum score =2
1. Who sets objectives of monetary policy? a) only central bank 1 b) central bank and government 0.66 c) by statute 0.33 d) none/government 0
2. Is central bank subject to possible interference in monetary policy? yes=0; no=1
Objectives: maximum score =3
3. Clarity on final objectives of monetary policy (de iure) a) single and clearly defined =1 b) clear prioritisation of multiple objectives =0.5 c) no priority =0
4. Quantification of target (de facto) yes=1; no=0
5. Publication of economic outlook a) in the form of explicit forecasts =1 b) forecasts with assessment of risks =0.66 c) only general statement =0.33 d) no economic outlook =0
Ex post accountability: maximum score =3
6. Reporting mechanisms and procedures a) to minister (0.33) b) to legislature (0.33) c) other (for example, board) (0.33)
7. Regular appearance before parliament (de iure – de facto) yes=1; no =0
8. Conflict resolution procedures a) definition of conflict (0.33) b) procedures to resolve conflict (0.33) c) clear outcomes in case of failure to resolve conflict (0.33)
Governance responsibility: maximum score =2
9. Decision-making structure a) by committee =1 b) CEO only (one person) =0.5
10. clear and detailed explanation of appointment procedures; yes =1; no =0
Total maximum score =10

Source: Laurens et al. (2009: 137)

Appendix C:

The Eijffinger and Geraats (2006) Central Bank Transparency Index

This appendix contains the exact formulation of the central bank transparency index. The index is the sum of the scores for the answers to the fifteen questions below (min=0,max=15).

(1) Political transparency

(a) Is there a formal statement of the objective(s) of monetary policy, with an explicit prioritisation in case of multiple objectives?
No formal objective(s) =0.
Multiple objectives without prioritisation =1/2.
One primary objective, or multiple objectives with explicit priority=1.

(b) Is there a quantification of the primary objective(s)?
No=0.
Yes=1.

(c) Are there explicit institutional arrangements or contracts between the monetary authorities and the government?
No central bank, contracts or other institutional arrangements=0.
Central bank without explicit instrument independence or contract=1/2.
Central bank with explicit instrument independence or central bank contract (although possibly subject to an explicit override procedure)=1.

(2) Economic transparency

(a) Is the basic economic data relevant for the conduct of monetary policy publicly available? The focus is on the release of data for the following five variables: money supply, inflation, GDP, unemployment rate and capacity utilization.
Quarterly time series for at most two out of the five variables=0.
Quarterly time series for three or four out of the five variables=1/2.
Quarterly time series for all five variables=1.

(b) Does the central bank disclose the formal macroeconomic model(s) it uses for policy analysis?
No=0.
Yes=1.

(c) Does the central bank regularly publish its own macroeconomic forecasts?
No numerical central bank forecasts for inflation and output=0.
Numerical central bank forecasts for inflation and/or output published at less than quarterly frequency=1/2.
Quarterly numerical central bank forecasts for inflation and output for the medium Term (one to two years ahead),
specifying the assumptions about the policy instrument
(conditional or unconditional forecasts)=1.

(3) Procedural transparency

(a) Does the central bank provide an explicit policy rule or strategy that describes its monetary policy framework?
No=0.
Yes=1.

(b) Does the central bank give a comprehensive account of policy deliberations (or explanations in case of a single central banker) within a reasonable amount of time?
No, or only after a substantial lag (more than 8 weeks)=0.
Yes, comprehensive minutes (although not necessarily verbatim or attributed) or explanations (in case of a single central banker), including a discussion of backward- and forward-looking arguments=1.

(c) Does the central bank disclose how each decision on the level of its main operating instrument or target was reached?
No voting records, or only after substantial lag (more than eight weeks)=0.
Non-attributed voting records=1/2.
Individual voting records, or decision by single central banker=1.

(4) Policy transparency

(a) Are decisions about adjustments to the main operating instrument or target promptly announced?
No, or after a significant lag=0.
Yes, at the latest on the day of implementation=1.

(b) Does the central bank provide an explanation when it announces policy decisions?
No=0.
Yes, when policy decisions change, or only superficially=1/2.
Yes, always and including forwarding-looking assessments=1.

(c) Does the central bank disclose an explicit policy inclination after every policy meeting or an explicit indication of likely future policy actions (at least quarterly)?
No=0.
Yes=1.

(5) Operational transparency

(a) Does the central bank regularly evaluate to what extent its main policy operating targets (if any) have been achieved?
No, or not very often (at less than annual frequency)=0.
Yes, but without providing explanations for significant deviations=1/2.
Yes, accounting for significant deviations from target (if any);or, (nearly) perfect control over main operating instrument/target=1.

(b) Does the central bank regularly provide information on (unanticipated) macroeconomic disturbances that affect the policy transmission process?
No, or not very often=0.
Yes, but only through short-term forecasts or analysis of current macroeconomic developments (at least quarterly)=1/2.
Yes, including a discussion of past forecast errors (at least annually)=1.

(c) Does the central bank regularly provide an evaluation of the policy outcome in

light of its macroeconomic objectives? No, or not very often (at less than annual frequency)=0. Yes, but superficially=1/2. Yes, with an explicit account of the contribution of monetary policy in meeting the objectives=1.

Source: Eijffinger and Geraats (2006: 18-20)