Abstract

Japan’s new central banking law: A critical view

Ryoichi Mikitani and Patricia Hagan Kuwayama

Japan’s new central banking law, enacted in June 1997 with effect from April 1, 1998, takes several steps in the direction of assuring greater transparency, independence, and accountability for the Bank of Japan’s conduct of monetary policy. But with respect to the other functions of a central bank, it does no such thing. Instead, the approach has been to leave these traditional banking functions which are at least important as monetary policy narrowly defined – as much as practicable under the control of the government’s finance ministry. Most disappointing has been the opaque and haphazard process by which the new law was drafted and passed. This reflects badly on the maturity of Japan’s democratic institutions, and represents a discouraging start to the government’s “Big Bang” program of financial reform. However, the law does not, in itself, preclude the emergence of an independent and successful central bank: That outcome will depend much more on actions taken by BoJ officials over the next few years.

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Ryoichi Mikitani and Patricia Hagan Kuwayama[1]

I. Overview

The Japanese Diet enacted a new central banking law in June 1997 with effect from April 1, 1998. Consistent with its stated purposes, the law moves several steps in the direction of assuring greater transparency, independence, and accountability for the Bank of Japan's conduct of monetary policy. But with respect to the other functions of a central bank, it does no such thing. Instead, the approach has been to leave these traditional banking functions – which some would argue are even more important than monetary policy narrowly defined – as much as practicable under the control of the government's finance ministry. Perhaps the most disappointing part of the reform has been the process by which the new law was drafted and passed. Of course a faulty process does not always yield a bad result, but the process by which major laws are crafted and approved is an essential pillar of democracy. The logic behind this central banking law's genesis is extremely difficult to fathom, a fact that does not raise confidence in the maturity of Japan's democratic institutions. Moreover, it represents a discouraging start to the government's "Big Bang" program of financial reform. However, the law does not, in itself, preclude the emergence of an independent and successful central bank. That outcome will depend much more on actions that BoJ officials will take in the next few years.

II. Background

The Bank of Japan was created in 1882 at the initiative of the then Minister of Finance, Masayoshi Matsukata. Establishing a central bank was a natural part of the Meiji program for modernizing Japan's financial system, and its main objectives were in keeping with those of other nations that established central banks around that time: to reform the currency system, to establish

[1] This paper has benefited from useful comments from Benjamin Friedman and Hugh Patrick. The authors, of course, take all responsibility for its opinions and possible errors.

a single, universally convertible national money, to provide a sound basis for financing the national government, and to foster the general development of banking. Sixty years later, the Bank of Japan Decree was replaced by a new Bank of Japan Law, enacted under Japan's military government in 1942. The revision added a more modern-sounding mandate for monetary policy, but – not surprisingly given its origins – it did nothing to alter the central bank's status as a creature of the Ministry of Finance.

In contrast with what happened in Postwar Germany – where the central banking law underwent a thoroughgoing reform in the aftermath of World War II – the Bank of Japan law somehow escaped the Postwar reform movement that altered so many of Japan's institutions under the U.S.-led Occupation. Two later initiatives to reform the central banking law – in the late 1950s (1957-1960) and again in 1965 – failed to result in legislation. In each instance, the discussion foundered as attention was concentrated on turf issues – the politics of how powers were to be distributed within different agencies of the government. The more important question, of how the institution should be structured in order to yield the best central banking and monetary policy for the Japanese economy and its people, never made it to the forefront of this public struggle.

The latest, successful effort to enact a new law gained its impetus from failure: Bad monetary policy decisions were widely blamed for the asset-price "bubble" of the late 1980s and its subsequent painful bursting. And, following a popular outcry against the need to bail out "non-bank" housing loan institutions (the so-called *jusen)* at taxpayers' expense, the government was compelled to take some action to improve its institutions for making monetary policy and overseeing the financial system. A private advisory committee to the Prime Minister (the "Torii Committee") was thus organized at Prime Minister Hashimoto's initiative and its report was published in November 1996. It then went quickly through the standard legislative process, undergoing review in closed hearings by the Financial System Study Committee *(kinyu seido chosakai),* an advisory committee within the Ministry of Finance. The Committee's draft report was presented in February 1997, was accepted by the Cabinet, and became the basis for the law passed by both Houses of the Diet a few months later.

Incongruously – considering that the title of the Torii Committee's report was "Toward an Open Independence of the Bank of Japan" – much of the drafting was conducted in the private councils of the ruling LDP under the intellectual leadership of Ministry of Finance staff. Bank of Japan officials made important contributions, but much of their input was behind the scenes, requesting changes in a law that had been shaped by others. This diluted the influence of the most knowledgeable participants in the process. It also meant that the public discussion did not benefit from participation by Bank of Japan officials, legislators, or outside experts in central banking or economic policy. The consequences are clearly to be found in the vague and contradictory language of the two reports and the legislation itself. While it does make a nod at endorsing independent Bank of Japan monetary policy, the new law falls well behind the contemporary standard set by the newly created European Central bank, or that of the Federal Reserve in the United States. It is easy to imagine a different result if there had been a public discussion of principles: that is, about what a central bank is supposed to be, and what history and international experience teaches are the conditions fostering successful central banking and monetary policy. Just as important for the future, the Japanese people missed the opportunity that such a debate would have presented, to deepen their understanding about the role of their central bank and what they should expect from it. The importance of this omission should not be underestimated, both for the future of Japanese democracy and for the environment in which future monetary and banking policy will be made.

III. What is a central bank?

Historically, central banks have emerged at different times in different countries. The evolution of their role has been a matter of circumstance more than of plan. The earliest central banks, including the 17th century Bank of England, had as their main purpose assisting their governments with financing. Later, promoting the development of modern banking systems and regulating the issue of currency became important goals. In the 19th and early 20th centuries, the experience of repeated financial panics shifted focus once again, to the need for central banks to act as a stabilizing "lender of last resort." Since international flows of specie and (later) currency often played a critical role in destabilizing banking systems as well as in government finance, international monetary operations inevitably became another aspect of the role of central banks from early on. These three main functions – which nowadays we would characterize as the central bank's roles as banker to the government, as bankers' bank (center of the payments system and lender of last resort), and as international monetary authority – have come to reside in a single institution, the central bank, after a long historical evolution in virtually every modern economy.

The responsibility for something called "monetary policy," in contrast, is a relatively recent notion. It, too, arose not by intent but out of experience and necessity. Especially after central banks became non-profit institutions with the monopoly of currency issue and with responsibility for liquidity provision to stem panics, it became obvious that their actions had macroeconomic implications that must be taken into account. Central bankers found themselves having to regulate the overall liquidity supply in response to seasonal and balance-of-payments movements in ordinary times, and to sudden interruptions at times of stress. Over time, they also learned to look past these short-term operations (or "defensive" operations as they were once called by central bankers at the New York Fed), in order also to "dynamically" monitor the medium-term trends that they were fostering in the economy as a whole.[2] It was by this progression that central banks came to concern themselves with what we now think of as "monetary policy": a fourth role of the central bank, regulating the overall supply of money and credit in order to stabilize the value of the payments medium and thus contribute to orderly development of the economy as a whole.

[2] Robert Roosa (1956).

This function was not consciously envisaged for the early central banks, nor even as late as 1913 when the Federal Reserve was created. The Federal Reserve Act, in fact, set up the U.S. central bank for the purposes of providing an elastic currency, a means of rediscounting commercial paper, and more effective supervision of banking, and for "other purposes." The excuse for monetary policy lay only in this standard legislative afterthought of "other purposes." But as Allen Sproul, one of America's leading central bankers, once said, "the 'other purposes' have long since stolen the show."[3] The omission of monetary policy from the Fed's charter has since been remedied by the Full Employment Act of 1946 and the Full Employment and Balanced Growth Act (popularly known as the "Humphrey-Hawkins" law) of 1978. Central banks with more recent charters, including the Bank of Japan under its 1942 law, are explicitly charged with guiding credit provision in support of the orderly development of the economy as a whole: that is, with making monetary policy. But whether legislated or not, this role has arisen naturally everywhere as a corollary of central banks' original banking functions. The logical "glue" that holds all four of these functions together is evident from the fact that central banks have evolved in more or less the same way in every modern economy across the globe – not as the theoretical creation of some economist or bureaucrat but out of historical trial and error to meet the needs of a modern monetary economy.

IV. Problems in the new Bank of Japan law

If the four functions – as the government's bank, the bankers' bank, international monetary authority, and maker of monetary policy – never conflicted with one another, it would not be a difficult task to outline the desirable structure of a central bank. But in reality these often have to be balanced against each other, and judging the tradeoffs between them is an essential challenge of central banking policy. Many of the problems in the new BoJ law stem from the designers' attempt to impose an impractical separation of "monetary policy" from the other responsibilities. The law recognizes (albeit with some inappropriate conditions) the BoJ's independence with

[3] Sproul (1955) in Federal Reserve Bank of New York (1989), p. 24.

respect to monetary policy but not the other functions. The law is also "limitationist" in structure: that is, specifying in detail those matters that belong to the BoJ's domain and leaving all others implicitly to the Ministry of Finance. A third fundamental problem, at the core of much of the law's confusion, is the failure to clarify the Bank of Japan's position under the Constitution: whether it is responsible directly to the Diet, or to the Cabinet as a separate part of the executive branch, or indirectly as a subordinate organ of the Ministry of Finance.

A. Separation of monetary policy from central banking

The fashion for endorsing central bank "independence" has captured academic and journalistic attention in recent years, but the public discussion has focused almost entirely on the narrow area of monetary policy. This is understandable, since the other functions of a central bank tend to be ignored – much like the plumbing in a beautifully designed building – so long as they are conducted properly and work well. But the fact is – as was well described by Robert Roosa more than 40 years ago – that the more prosaic, or "defensive" functions of a central bank are usually conducted side by side with, and using the same tools as, the more glamorous matters of monetary policy. Attempting to separate "monetary policy" from other responsibilities of the central bank ultimately leads to contradiction and ambiguity that undermine the legislation's purpose of setting a clear mandate for an independent and accountable central bank.

Perhaps the oddest reflection of this schizophrenic approach is in the provisions for budgeting. The law (Article 51) requires the BoJ to prepare a budget for "current expenditures," defined as those not related to "currency and monetary control" *(tsuka oyobi kinyu no chosetsu,* the law's phrase for what we are calling "monetary policy"), and submit it for the Minister of Finance's approval before the beginning of the fiscal year. Since in reality there is no way to separate activities that are and are not related to monetary policy, the BoJ must be expected to submit either virtually its entire budget, or none at all, for Ministerial approval. However, the decision – which must necessarily be arbitrary – on which expenditures should be included is to be decided by a government Cabinet order *(seirei)*. In this provision – as in many other parts of the law – the meaningful support to BoJ independence comes from transparency: The MoF must publicly explain both the proposed budget and its reasons if it decides to disapprove. This may in fact seriously crimp the MoF's ability to dictate to the Bank of Japan, but it does not constitute recognition of the principle of central bank independence. It would have been more in keeping with the law's stated purposes – not to speak of practice in the United States and other advanced countries – to provide for the BoJ's budgetary accountability via publication and an independent review of its financial statements.

The law's provision for BoJ appointments also seems to reflect this division: The executives (Article 21) are to be: the Governor, two Deputy Governors, six "Deliberative Members" of the Policy Board, up to three Auditors, up to six Executive Directors, and an unspecified number of Advisors. The Governor, Deputy Governors, and Deliberative Members – making up the Policy Board which is charged with all important decisions on monetary and central banking policy – are to be appointed by the Cabinet with the consent of both Houses of the Diet. The Auditors are also appointed by the Cabinet, but the Executive Directors and Advisors are appointed by the Minister of Finance on the recommendation of the Board. The latter are charged with "administering the business of the bank," and this presumably reflects the notion that operational banking matters are done on behalf of the MoF rather than independently by the BoJ. Again, since the Policy Board must act on any matter of importance and is to include at least some outside members (the law provides that the Deliberative Members should be "experts on the economy or finance or persons with other academic background"), increased transparency may constrain MoF officials from interfering by use of appointments as they have in the past. But the law's language itself has done nothing to clarify the independent role of the BoJ.

B. Independence in conducting monetary policy

"Currency and monetary control" is the one area where it is explicitly recognized that the Bank of Japan should have some autonomy. Even here, though, the law eschews the use of the word "independence" *(dokuritsu)* – the term that was almost always used in public discussion of this matter up to the 1997 drafting in favor of the vaguer phrase "respect for the Bank of Japan's autonomy" (*jishusei).* Article 3 states that the BoJ's autonomy shall be respected, and that it shall "clarify to the public the content of its decisions, as well as the process of decision making." In both cases, this provision is explicitly limited to the BoJ's activities with respect to currency and monetary control.

Some of the specific provisions about monetary policy are vague at best. Article 4, on the relationship with the government, says that: "recognizing the fact that currency and monetary control is a component of overall economic policy, the Bank of Japan shall always keep close contact with the government and exchange views sufficiently, so that its monetary policy and the basic stance of the government's economic policy shall be mutually harmonious." There is nothing wrong about this as a generalization, but its concrete interpretation is hazardous. Historically, language of this sort has meant that Bank of Japan monetary policy should accommodate itself to whatever economic policies the government had set. "Close contact" has meant accepting direction from the MoF except when BoJ officials succeeded in persuading them of their own point of view. Bank of Japan officials – in contrast with their counterparts in Germany or the United States – have not permitted themselves to comment publicly on fiscal policy even when its inappropriate stance placed monetary policy choices under unbearable constraint.

Even if one believes that the BoJ and MoF will be equal partners from here on, Article 4 embodies a theory of jointly determined fiscal-and-monetary "policy mix" that may not be appropriate in today's world. Of course, exchange of opinions and coordination of policy actions between the government and central bank are necessary to avoid contradictory effects of divergent policies that might be taken by the two bodies independently. But in practice, the views of the Ministry of Finance or of politicians have often dominated public discussion and often prevailed over the central bankers' views. Based on this historical experience as well as on economic analysis, many experts believe that fiscal and monetary policy should operate independently, with separate pre-assigned goals and separate instruments. Indeed, Article 2 does assign the BoJ responsibility for a single target, price stability – rather than for growth or full employment *and* price stability, as U.S. legislation does for the Federal Reserve. The law thus implicitly accepts the contemporary view that central banks should address themselves directly to price stability goals alone, even though the ultimate purpose is – jointly with the government – to promote sustainable growth over time in output and employment. Specifically, Article 2 says that BoJ monetary policy should "aim, through the pursuit of price stability, at contributing to the sound development of the national economy."

Also counter to the stated goal of independence is the provision (Article 19) that certain government representatives may attend and participate in Bank of Japan Policy Board meetings. The government representatives are allowed to offer opinions and proposals on any item placed on the Board's agenda, but not to vote. Similar provisions are not unknown abroad, but the trend is to eliminate this kind of government participation. Most relevant is the newly created European Central Bank, which in many other respects has been modeled on the German Bundesbank, but which does not retain the past German practice of occasional attendance by the Finance Minister. In the United States it has been over 60 years since the Treasury Secretary was taken off the Federal Reserve Board, and nearly 50 since the so-called "Accord" established the Fed's independence in setting interest rates. But even in the United States, deep sensitivities would be raised if there were the merest suggestion of an Administration presence at internal Fed meetings. Given the Bank of Japan's history of subordination to the MoF, the risk of a chilling effect must be all the greater. The inclusion of this provision thus seems directly contrary to the Law's stated intent, of fostering a newly independent central bank. Adding insult to injury, the law actually provides that the Minister of Finance and the Director of the Economic Planning Agency can attend themselves *or* designate staff members to represent them. Even in the rare instance when a government representation might be warranted, it surely should be the Minister himself who would engage in such meetings with the Policy Board, which is his counterpart as the highest policymaking authority of the Bank of Japan.

C. Payments system and lender-of-last-resort role

Article 1 of the law establishes two purposes for the BoJ: The first is currency and monetary control, with the goal of price stability, as already discussed. The second is described as: "to ensure smooth fund settlement among banks and other financial institutions, and thereby contribute to the maintenance of the orderly financial system." This gives recognition to the BoJ's role as center of the payments system, as well as its involvement in maintaining the "financial order" *(shinyo chitsujo).* But, when these phrases are viewed along with the specific provisions for emergency lending (in Articles 37 and 38), there seems to be an alarming lack of distinction between the central bank's responsibility for protecting the payments system and the government's possible interest in assistance lending to individual institutions.

Following standard principles that go all the way back to Bagehot, it is widely accepted that the central bank's lending should be to solvent institutions only, and should be not assistance lending but liquidity provided at market rates and on receipt of adequate collateral. Of course, this principle is easier to state than to apply. In times of financial market stress – the most likely times for this issue to arise – a bank can quickly change from "solvent" to "insolvent" at current market valuation of its assets. (As an example, experts still argue about whether Continental Illinois should have been bailed out in 1984, even though it turned out to be a profitable investment for the authorities. But U.S. law does require the Federal Reserve to take collateral, and to shift lending of this sort to a higher-interest-rate basis under its Extended Financing Facility whenever credit has to be extended for more than a few weeks.) The delicacy of judgments involved is what makes it all the more important that the central bank be empowered – and obliged – to act independently on banking principles. Since there may be macroeconomic consequences of a sudden liquidity injection to prevent systemic collapse, and the central bank may need to offset these in its later "dynamic" money market operations, this precisely illustrates why decisions to act as lender of last resort to protect the payments system must be made by the same independent entity – the central bank – that sets monetary policy. But instead of recognizing this principle, the law specifies that the BoJ can act on its own only in the very narrowest of conditions: when financial institutions "unexpectedly experience a temporary shortage of funds for payment due to accidental causes including computer system problems..." (Article 37).

Moreover, it says (Article 38) that the Ministry of Finance may request the Bank of Japan to lend in much broader circumstances: "when it is believed to be necessary for the maintenance of the orderly financial system including the case where the state of the business operations and property of a financial institution is believed to cause a serious problem in the orderly financial system." It does not say whether the BoJ can refuse to comply with such a request, nor what conditions it can or must set. This provision would not even, therefore, disallow a repeat of the 1996 *Jusen* bailout – in which the BoJ was required to lend to a non-bank, an entity with no critical direct connection to the payments system, on concessional terms, despite the nearly universal view among experts that this was not a suitable operation for a central bank. This muddying of the line between central bank and government responsibilities is unfortunately characteristic of the entire spirit of this law, which thus perpetuates exactly the kind of ambiguity that has kept the Bank of Japan from establishing its independence and accountability in the past.

D. Government finances

The central bank's role as the government's bank is the source of some classical dilemmas of central banking. Virtually every government has, at times, pressured its central bank into bending its interest-rate policy in order to facilitate cheap financing for its own activities. Indeed, the very concept of "monetary policy" presumes a separation of interest-rate setting from debt-management decisions that would not have existed for the earliest central banks, before the development of modern financial systems with open markets for government debt. Even in recent times, many examples can be found when the desire to fix rates paid on government issues interfered with the central bank's guidance of money market rates in line with macroeconomic balance. In the United States, this was precisely the subject of the fight that ended in the landmark 1951 "Accord," and the later steps to end the Fed's obligation to "even keel" Treasury refunding rates during the 1970s. (The 1951 "Accord" was reached after a bitter fight between the Truman Administration and the members of the Federal Reserve Board. The minutes of a meeting between President Truman and the Board members were made public by Governor Eccles in order to protest the President's one-sided interpretation of the agreement in favor of the Administration. The matter was resolved when the U.S. Congress and the public supported the Federal Reserve.)

Accordingly, it has long been conventional wisdom that central banks should be constrained by limits or collateral requirements for their own note issue, or prohibited from directly financing the government's debt, in order to protect the impartiality of monetary policy. Japan's new law has dropped the previous upper limits set by the MoF for BoJ note issue, a change that in itself is a reasonable adaptation to contemporary reality and in line with practice in other countries. But it provides no protection against the distortion of BoJ monetary policy by passive operations to monetize government issue. Far from prohibiting off-market financing of the government, the law simply directs the BoJ to lend under broadly defined circumstances without any reference to the policy tradeoffs involved. Article 34 says that the Bank of Japan can make loans without collateral to the national government, or purchase or underwrite its bonds, within limits set by the Diet under the Fiscal Law. It further provides (in paragraph 4) that the Bank of Japan can subscribe or underwrite financial bills and other bills issued for stopgap financing.

The latter is of more than academic importance, because it appears to endorse the practice of having the Bank of Japan directly purchase the government's short-term Financing Bills, issued at the Ministry of Finance's discretion, at below-market rates. (These bills are discounted at a rate below the Official Discount Rate, which itself is close to, and sometimes lower, than the rate for overnight funds available in the call market.) The Financing Bills currently amount to around ¥37 trillion (outstanding as of May1998), a substantial part of the Bank of Japan's overall liquidity provision. The Bank of Japan has proposed for some time that they should be issued to the open money market, not accepted directly by the BoJ, a suggestion that conforms to widely accepted principles of central banking. But the Ministry until now has not agreed, presumably because it did not want to add to the government's debt-servicing costs. It appears that the MoF is finally giving way on this. It has announced a plan to begin public tender of Financing Bills in fiscal 1999, ending their off-market acceptance by the BoJ.[4] The stated reason is the hope that market-priced FBs will become an attractive money-management vehicle for foreign investors (including central banks) and thus help to boost the yen. But, once again, it is disappointing that the newly drafted BoJ law did nothing to require this change as a step toward rational central banking, instead leaving it entirely to the MoF's discretion.

E. Foreign exchange and international monetary operations

The international monetary functions of a central bank are perhaps the hardest to define, since in all major countries governments play a leading role in setting exchange-rate policy and any treaty-related obligations in the financial realm. Also, institutional arrangements vary widely: As an example, the foreign exchange reserves that must be used in international operations are legally owned by the government in some countries; in others they are the property of the central bank.

[4] Nihon Keizai Shinbun, August 2, 1998, page 1.

In the United States and Japan, somewhat unusually, both parties independently own portions of the foreign reserves – a situation that seems to lend itself to having both the central bank and the government empowered to undertake such operations.[5] Many central banks conduct all of their governments' routine foreign exchange operations (for example, to pay for embassies or other operations abroad) as a matter of law. The U.S. and Japanese situations are unusual here, as well, in that both governments may and do use commercial banks for many of their non-policy-related transactions.

None of these institutional details seem to matter much, however, relative to the common realities: First, governments are responsible for underlying exchange-rate policy (including setting parities where those exist), but if a central bank is in charge of interest-rate policy then it controls the primary policy tool that can be used to carry out such policy. Second, a central bank must be able to operate with some degree of autonomy in the international financial markets in order to carry out responsibilities for both its payments system and its currency. As in the domestic realm, this discussion tends to be muddied by too exclusive a focus on the matter of exchange-*rate policy* as opposed to more operational activities of the central bank. The confusion is all the greater because of the strong views that many individuals hold about exchange-rate policy itself: some believing that parities should be permanently fixed, and others that monetary authorities should not intervene at all to set exchange rates. Presumably to avoid such objections, the BoJ law avoids the word "currency" *(tsuka)* in Article 2 where it sets the rationale for central bank's monetary policy, using the term "price stability" *(bukka no antei)* instead.

But exchange markets are part of a seamless web of global money markets, and a central bank inevitably finds itself involved in all if it is involved in one. This has always been true, since the value of a central bank's note issue – the currency – cannot be stabilized in some exclusively

[5] As of May 1998, the Bank of Japan owned ¥3.15 trillion at book value (probably about $22 billion) or about 11% of the foreign exchange reserves, which totaled $194 billion at that time. The Federal Reserve, as of February 1998, owned 55% of U.S. foreign exchange reserves: $17.2 billion out of a total of $31.2 billion.

"domestic" sense if its external value is unstable. Even more importantly, a central bank must sometimes operate in international markets for reasons that have nothing to do with exchange rate policy, but which instead are connected to its role as lender of last resort. An example that springs to mind is Charles Coombs' account of the events following the Kennedy assassination in 1963.[6] Coombs describes his solitary decision, as operational head of foreign exchange operations at the New York Federal Reserve, to undertake immediate and (by then standards) massive offerings of foreign currencies against the dollar. The decision came out of the obvious and urgent need to sustain confidence in the continuity of U.S. policies, when the dollar presented itself as a first line of attack in any panic. There were no bids for the dollar in the moments after the Kennedy news burst over the wires on that Friday afternoon. And, without action by the central bank, the dollar could have plummeted into this vacuum contributing to a dangerous atmosphere of panic in financial markets generally. A less dramatic, but conceptually similar situation occurred in May 1984 when Continental Illinois was rumored to be having difficulty funding itself in the Euro markets. The quick decision to purchase dollars clearly had no connection to exchange-rate policy – the dollar was officially viewed as overvalued at the time – but everything to do with keeping payments going and shoring up confidence in the U.S. financial system.

Central bankers from any other country could cite comparable experiences. But these U.S. examples make a few points. In the U.S. system, both the Treasury and the Federal Reserve have independent authority to intervene in exchange markets, but neither would normally choose to operate without the other's cooperation. In emergency situations like these, the Federal Reserve does sometimes go ahead without waiting for time-consuming consultations. The Kennedy episode was a rare, but illustrative extreme: Coombs describes committing borrowed resources under the Federal Reserve swap lines with foreign central banks *before* he had been able to reach his counterparts in either Europe or Washington. Once he did get to this, time zone constraints prompted him to call the European central bankers first and the Treasury last. The importance of

[6] Coombs (1976), pp. 92-106.

his established working relationships with operational counterparts in several central banks was also brought out by this account.

But at least as important is another point that – vital as American central bankers believe their independent authority to be – ultimately, such operations must have the full support of the government behind them to be successful. The case for autonomous central bank action is strongest in a lender-of-last-resort-type operation like those mentioned above. But it is precisely in those cases that any appearance of disunity between the central bank and the government would threaten the basic objective of maintaining confidence in the country's currency and financial system. So, while the Federal Reserve has sometimes expressed dissent from Treasury foreign exchange operations by refusing to join them (a fact that becomes public within a few months in the Fed's mandated reports), and jealously defends its right to operate on its own when the need is urgent, the operational autonomy of the Fed in no way denies the need for close coordination with the government. The result, in the U.S. case, is an implicit recognition of what Paul Volcker has called a "mutual veto" over exchange-market operations: Neither the Treasury nor the Fed can realistically try to achieve much with operations undertaken over the other's objection.[7]

Unfortunately, the new Bank of Japan law does nothing to lay out such a partnership between the Japanese central bank and the Japanese government in international matters. Instead, it seems to reinforce the traditional expectation that the Bank of Japan is essentially a "manservant" of the Ministry of Finance when it comes to foreign operations. Articles 40 and 41 specify that the Bank of Japan can operate in all the usual ways – conducting foreign currency transactions, handling business with foreign central banks and international institutions, and for the usual purposes of currency stabilization or international cooperation – but in each case acting as the government's agent, or conducting business designated by the Minister of Finance on his request or approval.

[7] Volcker and Gyohten (1992), pp.233 ff.

Japan is no different from any other modern economy in that it is the central bank whose day-to-day responsibilities keep it in close touch with the markets, and with operating-level counterparts in foreign central banks, making it the party that is both motivated and prepared to act quickly and effectively when the payments network comes under stress. And as financial markets become more and more interconnected, it is increasingly unrealistic to think of the "payments" network as divided between domestic and international components. The central bank must be prepared to act in both, and it should be expected to take the initiative when needed rather than being subordinated as a mere agent, hamstrung by requirements to obtain "requests" or "approval" from another party.

It may be, as with other aspects of the law, that this unfortunate phrasing will not keep the Bank of Japan from operating as it needs to in practice. Ultimately, the BoJ's role will evolve through experience and depend on the behavior of both its own and government officials. But the failure to spell out a realistic division of labor does have consequences at both policy and operational levels. At a policy level, Bank of Japan officials have long been extraordinarily reluctant to recognize the foreign exchange aspect of their monetary policy decisions, at least in public statements. This problem exists to some extent in all central banks, which naturally view any admission of exchange-rate considerations as a potential Trojan horse for the government to enter their interest-rate deliberations. Federal Reserve officials certainly have always been a little paranoid about admitting concern for the dollar: One, in the 1970s, compared the risks to those of the Fed's pre-Accord subservient pegging of Treasury debt prices.[8] Volcker's account of the Plaza discussions in 1985 brings home the same fear of being "locked into" to an essentially political commitment to target exchange rates.[9] And so did the events of the fall of 1989, when one FOMC meeting actually set down as a reason for its decision *not* to lower interest rates, the

[8] Maisel (1973), p. 208.
[9] Volcker and Gyohten, p. 245.

FOMC's desire *not* to be seen as influenced by a G-7 Finance Ministers' agreement to curb the dollar.[10]

But Federal Reserve officials, perhaps reflecting greater confidence in their recognized independence, are nowhere near as reluctant as BoJ officials to mention exchange-rate considerations – which after all do affect both economic activity and prices at home – as one of the influences on interest-rate policy. It is hard to know whether this reticence confuses the BoJ's internal policy debate. But there can be no doubt that it confuses public understanding of the BoJ's actions. And public understanding is absolutely essential – both in the short run, for effective policy implementation which depends on the financial markets' response, and in the longer run for preserving the central bank's independent standing vis a vis the government.

At an operational level, the ambiguous authority of the central bank tends to limit its choice of instruments. European central banks, as an example, have traditionally made extensive use of foreign exchange swaps for adjusting liquidity in their domestic money markets, while the Bank of Japan and the Federal Reserve have never done so. Foreign exchange swaps are an interest-rate operation in economic terms, but a foreign currency operation in law, and one reason that these two central banks have not used them is undoubtedly the fear that they might come under government purview in a way that other money-market operations do not. This is not a serious practical problem: The U.S. money markets have long been far better developed than U.S. foreign exchange markets. And the Bank of Japan has always had effective day-to-day control of very short-term interest rates via central bank lending operations (the discount window having been until 1995 a primary, and highly efficient, method of day-to-day liquidity adjustment). And it now has a variety of money market operations including repurchase arrangements that it can use. But the restriction does seem a little silly, and could conceivably become a practical constraint in a

[10] FOMC (1989).

future world – given the trend toward globalization which is blurring distinctions between "international" and "domestic" market instruments in all areas of finance.

F. Accountability and reporting

One of the great missed opportunities of this legislation was to clarify the position of the Bank of Japan under the Constitution. Japan's Constitution establishes three main branches of government: the legislature, the executive, and the judiciary. The Torii Committee, to judge from the fragmentary public record of its deliberations,[11] took it as given that the Bank of Japan is part of the executive branch which, under Article 65 of the Constitution, belongs under the control of the Cabinet. But much of the discussion in Japan has centered on the idea that the Bank of Japan belongs to the "administrative" realm (a vague concept called *seifu*, which is not mentioned anywhere in the Constitution) and thus must report to the Cabinet through a responsible Ministry – that is, the Ministry of Finance – rather than directly. The constitutional issue was in fact debated during the previous discussion of a new Bank of Japan law, in the 1960s, and resolved in favor of the view that the Constitution does allow the Bank of Japan to report directly to the Cabinet. But this appears to have been entirely forgotten in the latest round, at least as far as can be told from the public record. Newspaper reports in fact claimed that the law's wording was guided by concern that calling for Bank of Japan "independence" would be unconstitutional, although this flies in the face of the established conclusion by legal scholars.

Whether out of confusion, or based on a new interpretation of the Constitution (with an astonishing lack of debate), the practical implication of this is found in the reporting 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

[11] Central Bank Study Committee minutes published in the October 1996 issue of *Kinyu* magazine (minutes of the Committee's meeting on September 11, 1996). The Committee's minutes refer alternately to *seifu* and *naikaku* (Cabinet), but the assumption seems to be that the BoJ can operate lawfully only under the close supervision of MoF officials.

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 Bank of Japan report indirectly, other than to underscore that it is *not* an independent agency with responsibility directly to the Cabinet.

V. What to expect?

In sum, the new Law, despite its stated purpose of establishing an independent central bank, is full of restrictions that – certainly symbolically, and possibly materially – deny the BoJ's right to operate in markets, set its own budget, or frame policy as an autonomous agent. Still, flawed as the legislation is, it is not a reason for despair about the Bank of Japan's future role. Historically, legal language has been important, but it is not the all-or-nothing key to a central bank's independence or success. The Federal Reserve is a good example: The 1913 Federal Reserve Act was enacted under the gold standard and its operating guideline was the real bills doctrine, two principles that do not necessarily yield consistent prescriptions for policy. The Fed's present position has been hard-won in fights over actual policy decisions, and owes much to the events and personalities involved. (This includes not only central bankers, but also Congressional leaders like Senator Paul Douglas from Illinois: who helped conclude the 1951 dispute by calling for the Federal Reserve to "gird its legal loins and fulfill the responsibilities which I believe the Congress intended it to have."[12]) Most importantly, the Fed's standing has been bolstered by a relatively successful record of policy judgments in recent decades, gaining it a legitimacy in voters' eyes that would help to protect it against any Administration attempt to meddle. The original Federal Reserve Act is been supplemented over time by legislation that sought to adapt to contemporary economic and social reality: Among the most important are the Banking Act of 1935, the Employment Act of 1946, the Full Employment and Balanced Growth Act of 1978. Similarly, the German Bundesbank's often-cited independence owes much to past success and public trust, and not just to legislation.

[12] Sproul collection, p. 64.

It would have been useful if the new law had helped to point the way, but in any circumstance it is bound to be Bank of Japan officials themselves that face the essential challenge over the next few years. They need to seize their independence – not expect it to be handed to them, which it clearly has not been – and to use it wisely. The catch-phrases of “transparency” and “accountability” – while not, unfortunately, applied to the drafting of the law itself – provide a basis for the BoJ to challenge interfering governments and to utilize informed public debate to garner support of good policies (both its own and those of the government).

The BoJ already has begun making active use of this opportunity: expanding its internet “web” site to include a variety of informative data and analysis; making its economic analyses accessible through frequent outlook publications; and publishing remarkably frank and detailed accounts of the Policy Board’s twice-monthly deliberations. The new Governor, Masaru Hayami, has been more forthright than his predecessors in his comments on government policies that impinge on central banking – including fiscal policy as well as policies regarding banking problems and the financial system. The government’s appointments to the new Policy Board have had a heavy admixture of politics – some qualified more by constituency than by expertise. But the nine-member Board now has two outside economists and two industrialists who have already increased the depth and range of public debate on monetary policy – even offering dissenting proposals for the record over their individual names. Within the constraints that any central bank must place on its official statements, the BoJ thus seems to be moving away from the Japanese tradition of a silently subordinate central bank – a tradition that kept BoJ officials from weighing in even on the main issues in its own central banking law during the 1996-1997 debate. In operating matters, BoJ officials seem to have finally won their argument with the MoF about market issue of Financing Bills, despite the lack of support from the new Law. And they appear to be pushing the envelope of permitted independent action in other areas as well – one example being the investment of the BoJ’s own foreign exchange reserves.

These signs are hopeful, but it will take some years to see whether the quality of monetary policy decisions actually improves under the new regime. A great deal depends on changes that the new leadership will make in the BoJ itself, reorienting the behavior of a staff who were trained in the old regime. The success of internal reforms that the Bank of Japan has already begun undertaking (some long before the new law was even conceived), in order to equip itself for a new role and accountability, will thus be critically important. The hardest of all will be changing how staff are selected, motivated and rewarded. The choice is between (a) becoming an ever-more sleepy institution, attracting young people who are risk-averse and expect to be rewarded for keeping quiet and doing what they are told, and (b) attracting and keeping public-spirited staff who will argue, even with their bosses, about what the central bank should do and who will go elsewhere if they are not stimulated and empowered. Since the old-style prestige and *amakudari* rewards[13] are withering under the hot wind of public criticism, the first of these trends is already in place; changing to the second one requires strenuous effort on the part of management. But if it makes this effort successfully, this could be a fine opportunity for the BoJ to enhance its standing and effectiveness. After all, it may be better prepared for change than many of Japan's government ministries, which face the same problems in possibly even greater degree. One thing is certain: The next few years will be interesting and important to watch.

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[13] The term *"Amakudari"* literally means to descend from heaven to earth. It refers to the "golden parachute" by which a senior official (for instance, of the MoF or the BoJ) descends into a high position in a private bank. Usually this is when he will receive a significant portion of his lifetime earnings, which have been kept relatively low – compared to his status and power – during the years in public service.

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