Summary of Discussion at Financial Markets Panel (Forty-fourth Meeting)

April 5, 2018

Topic	Revision of the Bank of Japan Act revisited
Date	March 19, 2018 (2:25pm – 3:25pm)
Participants	**Ms. Miyako Suda,** Special Advisor, Canon Institute for Global Studies **Mr. Yoichi Takita,** Senior Staff Writer, NIKKEI INC. **Mr. Toshihiko Fukui,** Special Advisor, Canon Institute for Global Studies **Tetsuya Inoue,** General Manager, Financial Technology and Market Research Department, Nomura Research Institute (Organizer)

Key Discussion Topics

1．Policy environment surrounding Bank of Japan Act revisions

2. Monetary policy independence and accountability

3. BOJ's response to changing policy issues

1. Policy environment surrounding Bank of Japan Act revisions

Inoue (Organizer):

・I have informed today's participants in advance which topics we will cover today. The first issue for discussion is the policy environment surrounding revisions of the Bank of Japan Act. In the 1980s and the first half of the 1990s, central banks in the developed economies gradually abandoned their money supply targeting policies, and attention began to focus on the correlation between central bank independence indices and price stability. At the end of the 1990s the European Central Bank was established with the mandate of achieving price stability, and the independence of monetary policy was guaranteed by law. Additionally, the Bank of England achieved legal independence when monetary policy was excluded from the administrative directives of the HM Treasury. Inflation, one of the key reasons for giving central banks greater independence, had already begun to weaken in many developed economies.

Ms. Suda:

・The revisions to the Bank of Japan Act in 1997 were the result of many years of debate. The Financial System Research Council, formed in 1956 to conduct a fundamental review of Japan's financial system, had as its primary goal the revision of the old Bank of Japan Act, which had been passed during the war years. The independence of monetary policy was one of the topics discussed, and the government and BOJ were unable to reach an agreement on the question of how to deal with differences of opinion on policy decisions. The government argued that the competent minister should issue a directive in such cases, while the central bank maintained that the government should only have the right to request a postponement of the disputed decision. The report issued by the Council in 1957 therefore had to include both proposals, and no revisions were made to the Bank of Japan Act. Next, when Japan became an Article 8 nation of the IMF, the BOJ and the Ministry of Finance agreed that the Act should be revised to make it more suitable for the more open economy that Japan had pledged to become. A draft version of proposed revisions was prepared in 1965, but this, too, was never approved by the cabinet because it was judged that the Diet would not have enough time for the necessary deliberations.

・Through the first half of the 1970s, the BOJ was under steady pressure from the government to ease monetary policy in order to balance the nation's international payments and achieve a stable exchange rate. As a result, the mid-1970s brought high inflation and low growth (stagflation), which made it clear that the price stability sought by the BOJ and the economic growth that was the government's priority were not mutually contradictory but in fact complementary. During the 1980s, the theory of rational expectations emerged in the field of economics, and this led to a growing understanding that, at least in the long run, monetary policy could affect only prices and not the real economy. Starting in the late 1980s, there was active research into central bank independence (CBI) indices, which helped focus attention on the correlation between monetary policy independence and price stability. Reflecting these developments, people in government gradually came to accept the view that it would be appropriate to entrust monetary policy to the BOJ.

・The Maastricht Treaty underpinning the European Union guaranteed the ECB's independence in setting monetary policy, and consequently national central banks within the euro area followed suit. The Bank of England, which dropped out of the European Monetary System in 1992, adopted an inflation-targeting regime and then, in 1998, won a legal guarantee of independence for monetary policy. When eastern European economies migrated to capitalist economic systems following the collapse of the Soviet Union, monetary policy independence was also a key issue during the creation of their new central banks. In this way, it gradually became common practice for foreign central banks to have an independent monetary policy.

・In the 1980s, the G7 and other international bodies often discussed the need for Japan to reduce its current account surplus or to allow a stronger yen. The fact that this sort of international coordination became a priority in Japan's economic policy was a key reason why the BOJ was slow to tighten monetary policy. Markets responded by projecting an extended period of monetary accommodation, sending asset prices sharply higher and eventually leading to the collapse of the nation's asset bubble. Ironically, it was because of this and the non-performing loan (NPL) problems that followed that the Japanese public began to pay more attention to monetary policy, and debate regarding the objectives of the central bank moved into the spotlight.

・Meanwhile, the project team organized by the ruling party issued a report regarding future directions for financial administration and expressed the view that the Bank of Japan Act should be revised to ensure the independence of monetary policy and clarify responsibility for policy decisions. Based on this report, the Central Bank Research Committee was established as a private advisory body to Prime Minister Hashimoto with the aim of examining what kind of central bank was needed to form the core of a 21st century financial system. The results of this discussion were released as a November 1996 report that focused on the theme of "open independence" for the central bank, in which the Committee emphasized the importance of legally ensuring the independence and transparency of monetary policy.

・At the time, private-sector financial institutions were focused almost exclusively on disposing of their NPLs, but the government wanted to revitalize Tokyo's financial markets and transform the city into an international financial center. The revisions to the Bank of Japan Act were one element of this series of financial system reforms.

Mr. Fukui:

・I joined the Bank of Japan in 1958, and it was right after the Financial System Research Council started the first discussions about a revision of the old Bank of Japan Act in August 1957. I read through then existing Act as a student of Law after I received the preliminary job offer from the BOJ. At the time, the Act seemed to me completely out of date. The Act took effect in 1942, a time when I was an elementary school boy and wanted to become a Navy officer in the future, so I reflect that in a sense the Act was well-suited to such an era. I also read a book by well-known author Saburo Shiroyama titled "Bank of Japan: A Novel," which described the BOJ as a starchy place to work and also a place where personal relationships were tricky to navigate. However, once I actually began working there, I recognized that the BOJ is the place where its approach to both work and relationships had been rather flexibly transformed along with circumstances. By contrast, The Bank of Japan Act had not been revised, and the central bank had to discuss any action it wanted to take with the Ministry of Finance. The difficulties this caused grew worse over time.

・Discussions about revising the Bank of Japan Act came up on the surface during Showa 30's (from 1955 to 1965), when the government's Economic White Paper declared that the nation had emerged from the "postwar" era. In other words, this movement was in line of the view that Japan's economy accomplished its reconstruction process and so called "financial normalization"—the creation of a financial system suited to the peacetime development—was necessary. However, the discussion did not lead to approval of central bank independence, in part because of the rigidity that still characterized Japanese society. Opinion was split on whether the government should keep the right to indicate monetary policy decisions or whether it should only have the right to request a deferment of BOJ decisions. To conclude, both views were included in the report.

・As a result, the process of revision of the Act was frozen. In the meantime, however, the conditions surrounding the discussion continued to evolve. In 1963, Japan was welcome back to the club of economically advanced countries as it became an Article 8 nation of the IMF and joined the OECD. In the transition to the regime of open economy, there was growing support in Japan for revising the Bank of Japan Act. The Ministry of Finance also sounded out the BOJ on whether a compromise might be found between the two positions. I myself was working for the BOJ's Policy Planning Office and was directly in charge of the tasks to revise the Act. I remember well finishing work on a bill eventually after difficult coordination with the Ministry of Finance. The standoff described above was resolved in the way to have talks between the government and the central bank so as to set a coordination on any problems that might arise. The BOJ even edited a point-by point commentary of the bill, but in 1965 the ordinary session of the Diet had a great deal of legislation to work through. That, coupled with the Upper House election that year, made it impossible to secure adequate time for deliberation, and finally it was decided not to present the bill to the Diet. This was very unfortunate, even though there may still have been some opposition to the bill.

・The BOJ continued implementing policy and carrying out its duties under the old Bank of Japan Act until 1998, which led to much hardship. Japan's economy underwent a rapid globalization starting in the 1980s, and the explosive adoption of the internet from around 1995 ushered in the IT revolution. Ultimately, these dramatic changes helped bolster support for revisions to the Act in spite of Japan's rigid society. From the BOJ's perspective, the revisions took a great deal of time in the end, but just about to reach the turn of century we changed our minds to explore the new way of central banking with utilizing the new Act to the greatest extent possible.

Mr. Takita:

・In the media, which is where I work, there was also active support for revisions to the Bank of Japan Act. The accepted view was that Japan's bubble had occurred because the BOJ was forced to ease monetary policy (and delay a shift to a tightening bias) in order to minimize the adverse impact of the rise in the yen agreed to under the 1985 Plaza Accord, which sought a correction in the overly strong dollar.

・When Finance Minister Kiichi Miyazawa and US Treasury Secretary James Baker reached an agreement on exchange rate stability in 1986, Japan lowered its official discount rate as a quid pro quo. The next cut in the discount rate was also a quid pro quo for the Louvre Accord in 1987. Also in 1987, then-Deputy BOJ Governor Yasushi Mieno indicated his intention to raise rates in an off-record discussion with media representatives, but the stock market crash on Black Monday caused the rate hike to be delayed. In December 1989, a major newspaper reported that the central bank was planning to increase the official discount rate on the same day as a ministerial conference to discuss the government's Monthly Economic Report, which infuriated Prime Minister Hashimoto and caused the BOJ to scrap plans for the rate hike. The general view was that politics was a major obstacle to policymaking at the BOJ under the old Bank of Japan Act and often delayed its policy response. Even with the benefit of hindsight, I think the revisions to the Act were right for the time.

2. Monetary policy independence and accountability

Inoue (Organizer):

・The second issue we would like to discuss today is the independence and accountability of monetary policy. The report released by the Central Bank Research Committee, which held discussions in preparation for a revision of the Bank of Japan Act, used the phrase "open independence" in its title. It recommended bolstering the independence of BOJ monetary policy and also asked the central bank to explain its decision-making process and the basis for its policy decisions to the Diet, the public, and global markets. The concept of accountability presented in that report was still relatively uncommon, and I myself remember finding it rather hard to understand. Regarding transparency, major central banks certainly provide more information now, publishing official statements and meeting minutes and submitting reports to national legislatures. However, I am not sure whether quantity alone is sufficient.

Mr. Fukui:

・The Central Bank Research Committee was an advisory body for the prime minister. Chaired by Keio University Chairman Yasuhiko Torii, it brought together a select group of experts that discussed revisions to the Bank of Japan Act before the Financial System Research Council. Ms. Suda was also a member of the Committee. It is my understanding that the Committee's basic message was that the Bank of Japan should be a central bank that could serve as the core of a 21st century financial system. It argued that this would require not just independence but "open independence"—in other words, while the BOJ would be given the independence to make its own policy decisions, it would also be responsible for thoroughly explaining to the public why it made those decisions and what strategies were behind them.

・The BOJ took that message to heart and strived to put it into practice. The revised Bank of Japan Act charges the central bank with contributing to the nation's economic development by ensuring price stability. Inasmuch as the BOJ is being asked to serve as the core of a 21st century financial system, this provision means the BOJ must contribute to the development not only of the domestic economy but also of the global economy. To the extent that both the benefits and costs of policy can be transmitted overseas as economies grow more globalized, it is important that the BOJ takes into account the delicate chains between the domestic and global economies when making policy decisions.

・Even before the Central Bank Research Committee emphasized the need for accountability, the BOJ believed it had made efforts with intention to explain its actions to the public. However, the revised Bank of Japan Act stipulated its measures. These included 1) preparing semi-annual reports on its operations for the Diet and conducting its briefings, 2) having senior officials present when requested by Diet committees to clearly answer their questions, 3) publishing minutes of monetary policy meetings in a timely manner, 4) publishing full proceedings of those meetings after a certain amount of time, and 5) submitting a summary of its operations each fiscal year and holding its briefings. In fact, the BOJ also sought to improve its dialogue with the public by offering detailed explanations of its policies at press conferences, and by having the governor, deputy governors, and Policy Board members visit other parts of Japan and have face-to-face discussions with local business leaders. The BOJ is emphasizing its dialogue with the general public through these efforts.

・In the global economy of the 21st century, a central bank must do more than simply explain its policy decisions to a domestic audience. It must also share proper understandings of its policy actions with other countries. Because it must first ensure smooth interactions between domestic and overseas markets, it needs to conduct policy with an eye on communication via global markets. Its dialogue with other central banks must also be closer than in the past. For that to happen, the BOJ not only has to explain its own policy decisions but must also engage in deeper discussions to such an extent as reach a touch of imagination about the possible next policy directions with each other. When I served as BOJ governor, I attended all of the meetings where my presence was requested.

・As its prerequisite, the ability to provide detailed explanations of policy decisions to the public and engage in extensive discussions with other central banks requires thoughtful discussions at Policy Board meetings. Instead of Board members simply “following the wind” when arriving at decisions, it is important that they bring new arguments or research outcomes to each meeting and engage in a process of extensive debate based on that information. Only in that way can BOJ officials provide vital explanations of policy decisions and have good ammunition when talking to people overseas. Respect for minority opinions in the Policy Board discussions is also important. Simply presenting a dissenting view as a kind of “alibi” when a Board member does not agree with the majority vote does not constitute a valid minority opinion. A real minority opinion is one that presents an alternative view of the future, and other Policy Board members need to respect such views and strive to make use of them at future meetings.

・The Central Bank Research Committee’s report states explicitly that if the BOJ is to earn the trust of global markets and the Japanese public, it needs to do more than just establish the necessary systems and structures; the people involved in the policymaking process at the central bank must recognize the importance of their public mission and strive unrelentingly to make the right policies. Policymakers who rest easy in the knowledge that the Act ensures their independence or who convene Policy Board meetings in name only, putting out perfunctory minutes for public consumption, are not fit for duty. The Policy Board must engage in extensive discussion and strive to convince the public that it will in fact take responsibility for its policy decisions. True independence is only possible if the BOJ gets the public’s trust. That was the message of the Central Bank Research Committee, and it is a message that the Bank of Japan has taken to heart.

Ms. Suda:

・The Central Bank Research Committee’s report repeatedly noted the need for the BOJ to earn the trust of the markets and the public and emphasized that that was why independence and transparency were so important. Much of the Committee’s discussion of accountability focused on its role in enhancing central bank independence, but today I think that explaining policy decisions is also an important way to enhance the effect of monetary policy. On the subject of central bank independence, it was decided that under Japan’s constitutional framework the right to appoint BOJ officials would have to remain with the government, which is why the cabinet nominates the BOJ governor, the two deputy governors, and Policy Board members, who must then be confirmed by the Diet. In practice, tightening monetary policy is likely to create a great deal of tension between the central bank and the government, and in that sense it is questionable just how independent the BOJ actually is.

Mr. Takita:

・On the subject of central bank independence, I am reminded of the decision under Governor Hayami to wind down the zero-interest-rate policy in the summer of 2000. In retrospect, I think the BOJ was probably overextending itself in a sense under the revised Bank of Japan Act. In a subsequent internal summary, the BOJ apparently deemed that this decision, made at a time of an underlying deflationary trend, was inappropriate. In contrast, the removal of quantitative easing in 2006 and the rate hikes in 2006 and 2007 seem to have been implemented quite smoothly under Governor Fukui, with the central bank striving relentlessly to earn trust in its policies, pulling back when the markets pushed and pushing when the markets pulled back.

3. BOJ’s response to changing policy issues

Inoue (Organizer):

・The third issue we would like to discuss today is the changing policy issues confronting the central bank and its future response to those issues. Some of the issues considered when the Bank of Japan Act was revised are basically unchanged today, while for others a consensus has yet to form on how best to address them.

And as noted earlier today, new policy issues have also emerged in response to structural changes in the economy and financial system and the measures implemented by Western central banks. Does the current Bank of Japan Act provide the BOJ with sufficient flexibility to respond to these changes?

Mr. Takita:

・One key policy issue since the Bank of Japan Act was revised is the more pronounced deflationary pressure in evidence since a number of large financial institutions collapsed. Upward pressure on the yen has also had a deflationary impact. The BOJ has had to deal with a rising yen on numerous occasions, but in 2003-04 it engaged repeatedly in quantitative easing as the government undertook large-scale currency intervention to drive the yen lower against the dollar. Under Secretary of Treasury for International Affairs John welcomed unsterilized intervention. However, I suspect that Mr. Fukui, who was then governor of the BOJ, was willing to tolerate a certain amount of error if it enhanced the policy effect. Zembei Mizoguchi, then-Vice Finance Minister for International Affairs in Japan, said something similar, suggesting that the BOJ and the government were closely coordinating their actions.

・Meanwhile, I think the Bank of Japan lost the currency devaluation war against overseas policy authorities at the occasions of the Global Financial Crisis and the global recession afterwards under Governor Shirakawa. Earlier today, there were somewhat polite comments about the transmission mechanisms for unconventional monetary policy, but the reality is more straightforward. For example, former Fed Governor Kevin Warsh explicitly stated in a speech that traditional monetary policy works via interest rates, while quantitative easing works via exchange rates. I believe this was the Fed's explicit strategy under Chairman Bernanke and not just Mr. Warsh's personal opinion. In contrast, the BOJ's approach under Mr. Shirakawa and the DPJ administration at the time appeared to be too graceful. In the end, considerable appreciation of Japanese Yen with USD/JPY higher than 80 probably exacerbated Japan's deflationary recession.

・In January 2013, the Shirakawa BOJ and the Abe administration issued a joint statement regarding price stability. It fueled expectations early this year of a combination of additional easing from the BOJ and economic stimulus from the government. What is the market's view on coordination between the government and the BOJ in the event that the Abe administration's power base weakens? For instance, if a politician in opposition to Abenomics become Prime Minister, it would probably the case that the government might even call for a review of the joint statement. In that case, the government could reverse its position on QQE, which had been keeping the yen in check under the joint statement. In short, I think the BOJ may encounter policy issues other than its massive balance sheet or the difficulty of winding down QQE.

Ms. Suda:

・Most important policy issues we discussed when the Bank of Japan Act was revised was the price stability. We then thought that it could be achieved using conventional policy means, and that if unconventional policy approaches became necessary, the BOJ could ask the government for permission to use them as necessary. However, people did not foresee an extended period of zero interest rates and a blurring of the boundaries between monetary accommodation and exchange rate policy.

・Additionally, there was a longstanding view that the BOJ should consider buying foreign bonds under monetary policy. I also felt that exchange rates were the most effective way to influence prices and that using them as a policy instrument would be acceptable as long as it was consistent with any intervention being conducted by the Ministry of Finance. During the discussion at the Central Bank Research Committee, however, there was heavy opposition to the purchase of foreign bonds, largely because many of the BOJ's past policy missteps had involved exchange rates. Naturally, the distance between the BOJ and the fiscal authorities also became an issue when the Bank of Japan Act was revised. Today the central bank argues that buying large quantities of JGBs does not represent a monetization of fiscal deficits, but friction with the fiscal authorities is bound to arise when this policy is eventually "normalized."

Mr. Fukui:

・It is natural for policy agenda to go over along with developments in the economy and financial system, which is why monetary policy requires the constant invention of new policy device and tools. However, it becomes increasingly difficult for the BOJ to explain its actions when policy device and tools are modified in response to changing policy issues. Against this backdrop, it is essential that the central bank have the ability both to see far out into the future and to discern (and understand) what is happening right now. To predict the impact that structural changes in the economy and financial system will have in the future, central bankers must give extensive consideration to these issues in light of the latest economic and monetary theories in order to understand them and explain them to others. Only then should the central bank work gradually towards its inflation target or other objectives, for example.

・The latter requirement—seeing what is happening right now—is like piloting a plane. The pilot adjusts the controls based on what she sees through the front window of her cockpit, but there may be times when wind and rain prevent her from seeing anything. Such conditions are the norm when it comes to monetary policy, and policymakers must have the ability to work through such obstacles. While they must have a general sense of direction that is underpinned by economic and monetary theory, they must also be very aware of their immediate surroundings, and appropriately control the plane according to flexible and deliberate judgment. Only if the two are combined is a favorable outcome possible. Exchange rates represent at some occasions one kind of storm—and appears to be a fairly severe one at that—that these "pilots" face, and it is inappropriate to argue that exchange rates should be considered separately from monetary policy, or that they are not the responsibility of the BOJ. Unless professional decisions are made in this area, it will not be possible to return to an appropriate long-term trajectory.

・Revising the Bank of Japan Act took a great deal of time, but so did the liberalization of interest rates. I was one of the persons who worked intensely on interest rate liberalization when I was at the BOJ, but in the end it was not until 1994, after the asset bubble had collapsed, that deposit and loan rates were truly liberalized. Resource allocation can be optimized in a market with liberalized interest rates, and with new elements in the economy replacing the old, economic agents always have fresh opportunities. But just as that environment including liberalization of interest rates and revision of Bank of Japan Act had finally been put in place, Japan entered an era when zero interest rates and an extended period of quantitative easing were required. In other words, the BOJ employed the self-contradictory approach of shutting down the interest rate function while continuing to engage in market operations. In that sense, it was not long after the revised Bank of Japan Act took effect that conditions emerged making it extremely difficult for the benefits of the Act to manifest themselves.

・Quantitative easing supported financial institutions' balance sheets and helped to defuse concerns about the financial system in a deflationary era. If accompanied by a commitment effect, QE can serve to curb interest rates further out on the curve and give economic agents the time they need to carry out various adjustments. I am confident of these two effects from my own experience. On the other hand, I have the impression that the portfolio rebalancing effect—i.e., the effect achieved by supplying liquidity to the market and having economic agents find a way to spend it—has not fully been examined.

・When keeping suppress the interest rate function, we need to recognize their various potential side effects, including their ability to extend the lives of "zombie" companies and hinder innovation. In other words, they would prevent the restructuring of the industries. As such, the policy of leaving quantitative easing in place in a deflationary environment while waiting for businesses to revive their growth potential via innovation could be in fact a self-contradictory action in the end. While debate over when we should start discussing its exit is important, quantitative easing needs to have implicitly a built-in exit strategy in a well prepared manner.

Inoue (Organizer):

・I would like to ask Mr. Fukui one more question. First, I would like to say that I agree fully with his comment regarding the importance of extensive discussion and respect for minority opinions when making policy decisions. In practice, however, I think the current climate for policy discussion leaves a great deal to be desired—this is something that is found at many such forums and not just the Policy Board—in the sense that experts tend to exclude each other, and not respect, those having different opinions. How might this be resolved?

Mr. Fukui:

・The first condition is that the governor does not try to nip any discussion in the bud by expressing his own intentions to Policy Board members before they have had a chance to discuss an issue. In that sense, I think it would be better if Board members did not discuss to seek consensus in advance and instead made their decisions without a rehearsal, so to speak. That would force individual Board members to study up on policy proposals ahead of the meeting in order to make substantial contributions. More important is that the individuals who are chosen to serve on the Board have the knowledge and expertise required to engage in proper discussion of the issues at meetings. The cabinet and the Diet are responsible for appointing Board members, which makes it difficult for the BOJ to do anything on its own in that regard, but the qualifications for Policy Board members are clearly stipulated by the Bank. Inasmuch as fruitful discussion is possible only when Board members have the required knowledge and expertise, it is my hope that the cabinet and the Diet respect those conditions when choosing people with public oversight to serve on the Board.

Inoue (Organizer):

・With that I would like to conclude this discussion. Please give a warm round of applause to our panelists.

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