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The Non-Linear Process of Institutional Change: The Bank of Japan Reform and Its Aftermath

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Abstract

In 1997, the Japanese Diet revised the Bank of Japan law thereby granting the central bank greater independence in monetary policy making. The revision was an attempt by Japan's political class to weaken the authority of the powerful Ministry of Finance over the central bank and augment its own influence. The Bank of Japan, however, gained more autonomy than politicians ever intended, leading to frequent confrontations between the government and the central bank over monetary policy. This paper explores the new strategic relationship that emerged between the Bank of Japan and government and the nature of monetary policy implemented in the post-reform period. We demonstrate that several factors contributed to the Bank's unexpected ability to enhance its independence: the astute leadership of the first post-reform governor Hayami Masaru; the Bank's ability to turn politicization of monetary policy to its advantage; and its pursuit of a 'power through knowledge' strategy achieved by augmenting its own research capacity. On a theoretical level, our findings show that the passage of a new legal framework only marks the completion of one stage of institutional change and the start of the next; post-enactment politics have as much importance as pre-enactment politics in shaping outcomes. In the post-enactment phase, various factors, including the state of the economy and informal institutions or processes, matter greatly and may shift the direction of institutional change away from the intended path.

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In 1997, the Diet modified the Bank of Japan law (BJL) ushering in a new and turbulent era for the country's central bank. The reform was controversial from the start, affecting a wide range of political and economic stakeholders and contributing to significant restructuring of major public institutions in Japan. Though several scholars have examined the revision of the BJL, there has been much less work on the reform's aftermath.[1] This paper seeks to fill this gap. It examines the degree of central bank independence that the revision engendered, the new strategic relationship that emerged between the Bank of Japan (BOJ) and government, and the nature of monetary policy implemented in the post-reform period. We show that the BOJ gained more autonomy than the Diet ever intended, leading to frequent, serious confrontations between the government and the central bank over the course of monetary policy. We claim that one must examine the aftermath of the BJL revision to understand the ultimate impact of central bank reform in Japan and we analyze the factors that shifted the direction of institutional change from its intended path.

Traditionally, the BOJ was legally subordinate to the Ministry of Finance (MOF), which set overall monetary and financial objectives and supervised major operational decisions within a closed, opaque policy-making system. The new BJL gave the BOJ almost complete independence from the MOF and greatly enhanced the transparency of the monetary policy-making process. Nevertheless, lawmakers did not intend to create a fully autonomous central bank insulated from political forces in order to appease domestic or international actors who favored greater independence. Instead, they wished to weaken the power of the MOF over the BOJ while augmenting elected officials' influence over the central bank. Although they granted the BOJ more independence than before, politicians hoped to utilize formal and informal means to shape its policies.

Several domestic political changes in the 1990s – the decline of the Liberal Democratic Party's (LDP) hegemony, changes in the relationship between politicians and the bureaucracy, and public demand for greater accountability of economic policy makers – were the driving force behind the revision of the BJL. In the past, the MOF and BOJ often collaborated to keep politicians out of monetary policy making, though

[1] On the revision, see Tatewaki Kazuo, *Kaisei Nichiginhō* [The Revised Bank of Japan Law], Tokyo: Tōyō Keizai Shinpōsha, 1998; Yamawaki Takeshi, *Nihon Ginkō no Shinsō* [The Bank of Japan In-Depth], Tokyo: Kōdansha Bunko, 2002; Thomas F. Cargill, Michael M. Hutchinson, and Takatoshi Ito, *The Political Economy of Japanese Monetary Policy*, Cambridge, MA: The MIT Press, 1997; William Grimes, *Unmaking the Japanese Miracle*, Ithaca: Cornell University Press, 2001; Nakakita Toru, *Nihon Ginkō Shijōka Jidai no Sentaku* [The Bank of Japan's Choices in the Era of Marketization], Tokyo: PHP Shinsho, 1999, pp. 44–112; Jennifer Holt Dwyer, 'Explaining Central Bank Reform in Japan', *Social Science Japan Journal* 7, 2 (2004): 245–62; and James D. Malcolm, *Financial Globalization and the Opening of the Japanese Economy*, Richmond: Curzon, 2001. Miyao Osamu analyzed both the BJL revision and the BOJ's policies afterwards. However, his book did not systematically examine the BOJ's post-reform transformation, but instead focused on key events such as the lifting of the zero interest rate policy. See Miyao Osamu, *Nihon Ginkō no Kenkyū: Zero Kinri Seisaku wa Kō Tōsōshita* [A Study of the Bank of Japan: How the Zero Interest Policy Took Flight], Tokyo: Shougakukan Bunko, 2001.

key LDP officials, especially in its Policy Research Council and the *zoku* dedicated to MOF affairs, also played a significant role in influencing decisions.[2] With the advent of greater party competition, monetary policy making could no longer be contained within traditional insider networks centered in the MOF. Other political parties wanted to break the monopoly of the LDP over policy making and move it out of the MOF into a more transparent, politically-neutral setting. Moreover, as the Japanese economic situation deteriorated and financial scandals multiplied in the 1990s, the MOF, which received much of the blame, became a viable and attractive target for retrenchment and reform. Although strong ties between some LDP officials and the MOF made the former resist change, mounting pressure from its coalition partners and voters pushed the LDP-led government to pursue the breakup of the MOF along with central bank reform. Nevertheless, politicians hesitated to give the BOJ full autonomy, since voters were increasingly determined to hold elected officials responsible for economic performance; the solution was to make the BOJ independent from the MOF but responsive to the Diet.

Since the new BJL went into effect on 1 April 1998, the BOJ has become more independent than the Diet anticipated or desired. The Bank successfully rebuffed strong, direct pressure from political officials, the MOF and other government agencies, and international actors (notably, the United States and IMF) and followed an independent course that differed substantially from what most relevant actors wanted. Under the first post-reform governor, Hayami Masaru, the BOJ resisted aggressive monetary easing in the face of persistent deflation and even chose to raise interest rates in 2000, a move greeted with widespread opposition domestically and abroad.[3] This measure helped to snuff out an incipient recovery, perpetuate deflation, and throw the economy into a recession in 2001 and 2002, deepening hostility toward the central bank. More startlingly, BOJ officials sought to use monetary policy as a means of leverage to promote structural reforms of the Japanese economy.

Most observers feel that monetary policy improved under Fukui Toshihiko, Hayami's successor, helping to spark an economic recovery. The economic upturn and greater agreement over the course of monetary policy initially lessened politicization of the BOJ–government relationship. Starting in 2005, however, tensions flared anew as economic growth began to accelerate. As we detail later, the BOJ has begun to take the first steps toward a tighter monetary policy, provoking sharp protests and threats from leading government officials and other politicians who continue to favor an easy policy.

[2] The *zoku* refer to groups of LDP officials with special influence or expertise within a policy sphere.

[3] See Komiya Ryutaro (ed.), Japan Center for Economic Research, *Kinyū Seisaku Rongi no Sōten: Nichigin Hihan to Sono Hanron* [Areas of Disagreement in Monetary Policy: A Critique of the Bank of Japan and its Reponses], Tokyo: Nihon Keizai Shimbunsha, 2002; and Ben Bernanke, 'Japanese Monetary Policy: A Case of Self-Induced Paralysis?', in Ryoichi Mikitani and Adam S. Posen (eds), *Japan's Financial Crisis and Its Parallels to the US Experience*, Washington, DC: Institute for International Economics, 2000.

We contend that the revised BJL created a new strategic environment that fundamentally changed the constraints and opportunities confronting major actors, a development not anticipated by lawmakers. Indeed, Japanese lawmakers committed a classic error: in modifying the law they assumed incorrectly that central bankers would continue to behave as they had always done, largely deferring to political pressure. Instead, the revision changed the incentives facing BOJ officials and provided new means of advancing their objectives. Central bankers now viewed political pressure as unwarranted interference into the central bank's legal and moral prerogative to conduct independent monetary policy.

Politicians attempted to use a variety of informal and formal channels to influence central bank policy. At first, they focused on trying to intimidate BOJ officials by chastising them in private meetings and public fora or by requiring them to testify repeatedly before the Diet. Subsequently, they also employed the media to pressure the BOJ to accede to government demands, threatened to revise the BJL again to establish greater political control over the Bank, and made more assertive use of their right to appoint top BOJ officials. Several factors contributed to the BOJ's unexpected ability to withstand this pressure and even enhance its independence: the astute leadership of Governor Hayami Masaru; the Bank's ability to turn politicization of monetary policy to its advantage; and the BOJ's decision to pursue a 'power through knowledge' strategy achieved by augmenting its own research capacity.

On a theoretical level, our findings suggest that the process of institutional reform is much more complex, incremental, and open-ended than is sometimes believed. Passage of a new legal framework only marks the completion of one stage of institutional change and the start of the next; post-enactment politics often have as much importance as pre-enactment politics in shaping outcomes. In the post-enactment phase, relevant actors come to view their constraints and incentives differently and this transforms their strategic interaction.[4] In this phase, the quality of leadership, the state of the economy or polity, and informal institutions and processes matter greatly and may shift the direction of structural change away from the intended path in unexpected ways. This paper examines the factors that served to move central bank reform off its anticipated course in Japan. We believe that these factors have broader applicability for understanding the process of institutional evolution in other contexts.

More narrowly, the Japanese case illustrates the well-known difficulties of defining and operationalizing central bank independence.[5] 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. Formal statutes alone do not determine a central bank's level of independence; a variety of non-statutory factors also have a

[4] For an analysis of this issue, see Robert Jervis, *System Effects: Complexity in Political and Social Life*, Princeton, NJ: Princeton University Press, 1997.

[5] An introduction to this topic is Alberto Giovannini, *A Debate on Money in Europe*, Cambridge, MA: MIT Press, 1995, chapter 13.

large influence and our analysis of the variables noted previously contributes to the literature on this issue.

This paper is divided into four sections. The first section traces the genesis of the new BJL, describes its major features, and examines the political factors that motivated legislators to undertake central banking reform. The second analyzes the aftermath of the revised BJL, notably, the strategic interaction that emerged between the BOJ and government and the means by which the central bank asserted its independence in the period from 1998 to 2005. The third section examines three variables that help to explain why the BOJ was able to gain more independence *vis-à-vis* politicians than most actors anticipated. The final section explores some of the implications of our analysis.

The revision of the Bank of Japan Law

Genesis of the Law

The 1942 BJL placed the central bank under the direct supervision of the MOF, depriving the BOJ of the right to conduct independent monetary policies.[6] For instance, the law required the BOJ to obtain MOF approval to modify reserve requirements and to 'consult' with the Ministry to change its discount rate. Consequently, most scholars rated Japan as one of the least independent central banks among developed and even developing countries.[7] The BOJ's greatest ability to influence monetary policy was through the policy of 'window guidance', by which it set overall levels of bank lending (and how credit was allocated), but this practice began to lose importance by the 1970s.[8] Though interest in reforming the institutional structure of monetary policy making occasionally surfaced, sometimes stirred up by BOJ officials as in 1956, major changes to the BJL were precluded by strong opposition from the governing LDP party and MOF.

Monetary performance under this institutional set up, as measured by price stability, was generally good. Japan had a somewhat higher than average rate of inflation for a developed country from 1950 to 1975 (5.8%), but it had one of the lowest from 1976 to 1996 (2.8%).[9] In addition, economic growth was very high and unemployment extremely low, at least until the 1990s. On the negative side, most scholars believe that

6 On the relationship between the MOF and BOJ prior to 1997, see Kawakita Takao, *Nippon Ginkō – Nani ga Towarete Irunoka* [What Problems Confront the Bank of Japan?], Tokyo: Iwanami Shoten, 1995, pp. 60–7; and Randall Henning, *Currencies and Politics in the United States, Germany and Japan*, Washington, DC: Institute for International Economics, 1994, chapter 3.

7 See especially Alex Cukierman, Steven B. Webb, and Bilin Neyapti, 'Measuring the Independence of Central Banks and Its Effects on Policy Outcomes', *The World Bank Economic Review*, no. 9 (September 1992): 353–98.

8 See Cargill, Hutchinson and Ito, *Political Economy*, pp. 52–54. Window guidance was officially abolished in 1991. Richard Werner contends that window guidance was effective until the early 1990s, but this is a minority view. See Richard Werner, *Princes of the Yen*, Armonk, NY: M.E. Sharpe, 2003.

9 Cukierman, Webb, and Neyapti, 'Measuring Independence', pp. 370, 382.

monetary policy contributed directly to the infamous stock market and real estate bubbles during the late 1980s. They are also critical of monetary authorities' delay in reflating the economy in the post-bubble period (specifically, in 1992–95 and 1997).[10]

The barriers to central bank reform collapsed with the end of the LDP's political hegemony in 1993, mounting criticism of the MOF, and poor national economic performance during the 1990s. In early 1996, the LDP and its two coalition partners, the Socialists and Sakigake parties, began negotiations to restructure and downsize the MOF. Several financial scandals and the MOF's inability to address banking insolvency had begun to generate steady public criticism of the Ministry. With its coalition partners taking a strong anti-MOF stance, the LDP had little choice but to take up MOF reform.[11] The discussions focused on proposals to grant the BOJ greater independence from the MOF and move regulatory, supervisory, and inspection functions over the financial system from the MOF to an independent financial watchdog.[12] In July, after the parties had agreed on the desirability of making the BOJ more independent from the MOF, Prime Minister Hashimoto established a committee, the Central Bank Study Group, to examine potential changes to the central banking system; the group issued a report supporting greater BOJ independence in November. The Financial System Research Council, an advisory group to the MOF, also debated the issue and supported increased independence for the BOJ, though it argued for a continuing, but diminished, role for the Ministry. According to some authors, the BOJ was active in promoting the revision behind the scenes, but did not fight publicly for reform because it feared retribution by the MOF if it failed to gain independence.[13]

MOF officials did not relent, however, and they fiercely lobbied supporters within the financial *bukai* of the LDP, including ex-MOF officials, to halt the legislation.[14] In addition, Yamasaki Taku, chairman of the Policy Research Council suggested that the MOF should retain some control over the BOJ. Momentum behind the reform seemed to wane until Kato Koichi, secretary general of the LDP, and Yamasaki intervened

[10] For a summary of monetary policy and outcomes in the late 1980s and 1990s, see Toshiki Jinushi, Yoshihiro Kuroki, and Ryuzo Miyao, 'Monetary Policy in Japan since the Late 1980s: Delayed Policy Actions and Some Explanations', in Ryoichi Mikitani and Adam S. Posen (eds), *Japan's Financial Crisis and Its Parallels to the US Experience*, Washington, DC: Institute for International Economics, 2000.

[11] See Jennifer Amyx, *Japan's Financial Crisis: Institutional Rigidity and Reluctant Change*, Princeton, NJ: Princeton University Press, 2004, p. 167.

[12] Summaries of the events surrounding the BJL revision are found in Yamawaki, *Nihon Ginkō*, pp. 67–124; Robert J. Brown Jr, *The Ministry of Finance: Bureaucratic Practices and the Transformation of the Japanese Economy*, Westport, CT: Quorum Books, 1999, pp. 174–5; and Malcolm, *Financial Globalization*, pp. 89–101, 347–54.

[13] Cargill, Hutchinson, and Ito argue that the BOJ and MOF negotiated intensely behind the scene, but others like Nakakita Toru believe that the BOJ was not active in promoting its independence. See Cargill, Hutchinson, and Ito, *Political Economy*, p. 96; and Nakakita Toru, *Nihon Ginkō*, pp. 49–50.

[14] The *bukai* are committees or divisions within the LDP Policy Research Council that specialize in a given policy area; their approval is usually necessary for legislation or reforms to move forward. The committees are composed of LDP members who have considerable policy experience and often are former members of relevant ministries.

and convinced members of the financial *bukai* that BOJ reform was central to Prime Minister Hashimoto's overall economic reform program.[15] This change of heart was at least partly motivated by the growing disillusionment among the public. As the public became more frustrated with the lackluster economic reform effort, Hashimoto's approval rating steadily declined. The *Nihon Keizai Shimbun* public opinion poll on January 1996 showed that 54% of Japanese supported Prime Minister Hashimoto, but, by March 1997, this figure dropped to 36%, his lowest approval rating.[16]

With this new impetus, the government prodded the MOF to finish drafting the new BJL. After substantial changes, the Diet approved the bill in June 1997.[17] Effective on 1 April 1998, the new BJL gave the Policy Board, the BOJ's principal decision-making body, authority over monetary policy and established price stability as its primary objective.[18] The composition of the board was changed dramatically to include nine members: six outside financial and economic specialists plus the BOJ governor and two deputy governors. Previously, the MOF and Economic Planning Agency (EPA) had held two policy board positions without voting rights; under the new structure, however, government officials were not board members but only 'observers' and their attendance was no longer mandatory. The board's proceedings were to be disclosed to the public, with the deliberations of each bimonthly board meeting released at the subsequent meeting. The new law abolished most of the MOF's supervisory authority over the central bank's operations. In fact, the MOF was now limited to monitoring the BOJ's administrative budget.[19]

In contrast, the revision increased politicians' influence over the BOJ, giving them greater ability to intervene in the Bank's affairs, a point the press noted at the time.[20] First, the Diet gained the right to approve the Cabinet's appointments of the governor and vice governors. Starting in the early 1970s, the MOF had filled the position of governor alternately with BOJ officials and former MOF officials. For the government, the right to appoint the governor was a safeguard against ex-MOF officials taking leadership roles in the BOJ; indeed, the two governors in the post-revision era, Hayami Masaru and Fukui Toshihiko, have both been non-MOF officials. The Diet's right to

15 Brown, *Ministry of Finance*, p. 175.

16 On the role of public opinion in influencing financial reform during this period, see Toya Tetsuro, *Kinyū Bigguban no Seijikeizaigaku* [The Political Economy of the Japanese Financial Big Bang], Tokyo: Tōyō Keizai Shinpōsha, 2003, pp. 188–93.

17 In Japan, the competent ministry usually drafts bills in its policy area. See Grimes, *Unmaking the Miracle*, pp. 204–07, on the revisions of the draft submitted by the MOF. The Diet also enacted legislation shifting supervisory authority over the banking system from the MOF to Financial Services Agency. This change was aimed at ending administrative guidance and the convoy system, moving to greater reliance on market discipline, enhancing transparency, and restoring the stability of Japan's financial system.

18 For details on the changes from the old to new BJL, see Tatewaki, *Kaisei Nichiginhō*, pp. 77–118.

19 This was one concession won by MOF officials in their negotiations with government officials. See Brown, *Ministry of Finance*, p. 174. The MOF is prohibited from exercising its power over the administrative budget in a way that hampers currency or monetary policy. See Chapter VI (Accounting), Article 51 of the new BJL.

20 For example, see *Nihon Keizai Shimbun*, 12 June 1997.

dismiss the governor and vice governor under special circumstances remained intact. Second, under the new law, the central bank governor must attend Diet sessions when requested and present reports (*gyōmu hōkoku*) to the Diet at least once every six months; in the past, the BOJ only reported to the Diet once a year indirectly through the MOF. Finally, the Cabinet obtained the right to request a delay in Policy Board decisions and to place proposals on the agenda of the Board, rights that are highly unusual among advanced industrial countries.

The political objectives of legislators

In analyzing the genesis of the new BJL, one question stands out: what was the legislators' motivation in revising the legal structure of central banking? The answer is multifaceted, but the primary purpose behind the revision was to weaken the MOF's authority over the BOJ and increase that of politicians. Our explanation for this outcome has three principal elements.

To begin, the Japanese political environment was transformed in the early 1990s. A notable increase in party competition took place, best symbolized by the end of LDP hegemony, and the formation of coalition governments became customary. In 1989, the LDP lost its majority in the Upper House of the Diet for the first time since the foundation of the party in 1955. Loss of the more important Lower House followed in 1993, leading to the creation of a coalition government of eight non-LDP parties. In 1994, the LDP reentered the ruling coalition with the Sakigake and Japan Socialist Party. It regained its majority in the Lower House in 1996 allowing it to form a government with continued cooperation from the Sakigake and Social Democratic parties.[21] By the time central bank reform was being discussed, the LDP had reestablished itself as Japan's dominant party, but its electoral prospects remained uncertain and its need to respond to a broader spectrum of voters had grown.

This new political climate fundamentally altered the nature of the relationship between the bureaucracy and elected officials. In the past, the MOF and BOJ had often collaborated to keep politicians out of monetary policy making, though key LDP officials played a significant role in financial and monetary policy. The LDP would have preferred to maintain this privileged relationship, but the advent of real party competition meant that these exclusive insider networks were no longer tenable. Indeed, the MOF, under the leadership of Vice Minister Saito Jiro, had transferred its allegiance to the Shinshinto party in 1993 out of belief that this party would retain political power for some time, leaving many LDP officials in shock.[22] Further, as discussed later, the LDP eventually came to believe that its political prospects would be enhanced by dissociating itself from the MOF and traditional insider networks.

[21] The LDP was only able to reclaim its majority in the Upper House in 1999 by forming a coalition with the Liberal Party.

[22] Mabuchi Masaru, *Ōkurashō wa Naze Oitsumeraretanoka* [Why Was the Ministry of Finance Cornered?], Tokyo: Chūōkōronsha, 1997.

Consequently, since the LDP's dominance of policy making was no longer assured, bureaucratic structures and the policy-making process had to be made more transparent and politically neutral. As the MOF was considered the heart of traditional insider networks, achieving this goal required moving financial and monetary policy making out of the MOF to a more impartial setting in which no party would be able to dominate the policy-making process. At a minimum, this meant granting the BOJ greater autonomy from the MOF, making the BOJ more responsive to the Diet as a whole, not just the LDP, and increasing the transparency of its operations.

Second, severe criticism of the MOF because of the state of the economy and its involvement in a series of scandals in the 1990s created a window of opportunity for the Diet to discredit and downsize the Ministry and, among other things, shift authority over the BOJ away from it. The government's inability to revive the economy in the early to mid-1990s was increasingly blamed on the post-1955 economic system (*gojū gonen taisei*) and one of its primary architects, the MOF. In particular, the MOF was severely criticized for not confronting the banking crisis vigorously enough and for failing to spur economic growth through more expansionary fiscal and monetary policies. In 1995–96, MOF-bashing intensified as details about the bailout of failed housing loan companies (*jūsen*), 'loss compensation' schemes, and the Daiwa Bank scandal surfaced, creating a clear electoral vulnerability for the LDP-led coalition government.[23] In addition, MOF officials were implicated in a number of bribery and 'wining and dining' scandals that deeply angered the public.[24]

Still, the LDP did not pursue MOF reform energetically. As Jennifer Amyx notes, MOF reform was a 'drawn out and nonlinear process', reflecting the persistence of the 'longstanding network link between the MOF and the party'.[25] MOF supporters within the LDP, including new Prime Minister Hashimoto (a former finance minister), attempted to dampen their coalition partners' efforts to dismantle the MOF. Nonetheless, with the October 1996 election approaching and scandals mounting, the price of delaying the MOF reform became too high. The LDP decided to adopt financial regulatory and monetary policy reform as headline political initiatives, explicitly asserting the objective of stripping the MOF of much of its authority.[26]

[23] Other bailouts included that of Anzen Credit Bank, Tokyo Kyowa Savings & Loans Association, Cosmo Credit, and Kizu Credit. Nishimura Yoshimasa, the former director general of MOF's Banking Bureau, provides an insider's account of the *jūsen* problem and various financial scandals. See Nishimura Yoshimasa, *Kinyūgyōsei no Haiin* [Factors behind Financial Administration Failure], Tokyo: Bungei Shunju, 1999, pp. 123–64. On 'loss compensation' schemes, see Brown, *Ministry of Finance*, pp. 85–90.

[24] See Grimes, *Unmaking the Miracle*, pp. 199–202.

[25] Amyx, *Japan's Financial Crisis*, p. 164.

[26] Malcolm, *Financial Globalization*, pp. 91–2, 350. The major political parties also decided to wrest control over fiscal policy away from the MOF, though in the end the Ministry retained much of its power. See Hiromitsu Ishi, *Making Fiscal Policy in Japan: Economic Effects and Institutional Setting*, New York: Oxford University Press, 2000, pp. 134–7; and Maurice Wright, *Japan's Fiscal Crisis: The Ministry of Finance and the Politics of Public Spending*, New York: Oxford University Press, 2002, p. 205.

Thus, central bank reform became one means by which the ruling coalition could appear proactive in transforming the obsolete economic and bureaucratic systems that the MOF represented, especially at a time of mounting voter unrest.[27] In fact, the public was increasingly determined to hold elected officials and bureaucrats more accountable for economic performance.[28] Opaque, insider-based economic policy making was acceptable when the economy was strong, but not when conditions turned sour. Consequently, public support surged for reducing the authority of the excessively powerful and closed MOF and establishing more open and transparent policy-making processes. A *Nikkei* opinion poll on 12 March 1996 reported that a startling 74% of the public supported restructuring the MOF. Voters might not have had a clear idea of exactly what sort of institutional arrangement they would prefer, but public opinion was undeniably a force that politicians had to confront and a constraint on the types of proposals they could present.

We suggest that the pressure to hold elected officials accountable for economic performance contributed to the Diet's decision to increase the transparency of monetary policy and make the BOJ independent from the MOF but still responsive to politicians and voters. Many political officials certainly emphasized this theme. For instance, one politician argued that the BOJ should not be fully independent from the government, as in the case of the US Federal Reserve or Germany's Bundesbank, because, if it were, the Bank would not be subject to the legitimate 'voice' of the public.[29] The LDP's Sonota Hiroyuki, a member of the budget committee (*yosan iinkai*), also stressed that 'the checks-and-balances that the government can provide are indispensable for producing good monetary policies'.[30] Prime Minister Hashimoto and Shinshinto party's Kitawaki Yasuyuki argued that the BOJ should maintain a close relationship with the Diet and communicate effectively to produce sound monetary policies that would complement the government's economic plans.[31]

Although written subtly, Article 4 of the new BJL made implicit subordination of the BOJ to the government: 'In recognition of the fact that currency and monetary control is a component of overall economic policy, the Bank of Japan shall always maintain 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'. Two experts on the BOJ, Karube Kensuke and Tatewaki Kazuo, made two important observations on Article 4. First, the phrase

[27] In addition, some journalists argued that weakening the ties between the MOF and BOJ was necessary to dissociate the Bank from the Ministry's tarnished reputation and improve its standing in the financial community. See Aizawa Koetsu, *Nichiginhō Nijū Gojō Hatsudō* [Invoking Article 25 of the Bank of Japan Law], Tokyo: Chūōkōronsha, 1995, pp. 203–18; and Yamawaki, *Nihon Ginkō*, pp. 102–05.

[28] Kozo Yamamura, 'The Japanese Political Economy after the "Bubble": Plus Ca Change?', *Journal of Japanese Studies*, 23, 2 (Summer 1997): 294.

[29] 140th National Diet (Lower House), 28 January 1997.

[30] 140th National Diet (Lower House), 14 May 1997.

[31] 140th National Diet (Lower House), 17 April 1997.

'maintain close contact with the government' implied that the BOJ was now obligated to establish strong, direct lines of communication with and supply information to the government.[32] For example, the BOJ set up a Diet Liaison Section and appointed a senior Bank official to serve as an advisor to the governor for relations with the Diet and the press.[33] Second, the stipulation that the policies of the Bank and government 'shall be mutually harmonious' revealed an important assumption on the part of political officials: central bankers would be cooperative or easily influenced by political pressure as they always had.[34] As this paper shows later, this turned out to be a costly miscalculation.

Competing explanations of reform

Another potential domestic political explanation for the BJL revision is a shift in societal demands in favor of greater central bank independence. Scholars have suggested that the financial sector, which typically has the greatest interest in price stability, is normally the principal proponent of central bank independence and leads many reform movements.[35] In the case of Japan, however, the only visible lobbying for reform came from the *Keidanren* (Federation of Economic Organizations), which proposed increasing central bank independence in the fall of 1996. This proposal, however, emerged six months after the government's initial announcement indicating its intention to revise the law. In principle, banks viewed greater central bank independence favorably. Nevertheless, the dismal state of the Japanese banking sector during the 1990s, which made many entities reliant on the largesse and regulatory forbearance of the MOF, prevented banks from favoring central bank reform, as such support would go against the MOF's wishes. The banking sector's political influence was also very low due to emerging details about the extent of banking insolvency and shocking revelations about unethical and illegal behavior by many financial institutions.[36] Finally, monetary performance in Japan, as measured by price stability was excellent, weakening the traditional rationale for the financial sector to be a strong advocate of central bank independence.

One can also identify 'international' explanations for BOJ reform. One view might be that external pressure on Japan (*gaiatsu*), either in the direct form of diplomatic pressure or indirect form of capital flight, led the government to reform its

[32] Tatewaki, *Kaisei Nichiginhō*, pp. 85–86.

[33] For details on the BOJ's operational and administrative structures, see the Bank of Japan, 'The Self-Assessment Report on Transparency Practices for Monetary Policy', 16 August 2002 at http://www.boj.or.jp/en/about/basic/etc/data/fsap02.pdf (1 June 2005), p. 17.

[34] Karube Kensuke, *Zero Kinri–Nichigin vs. Seifu Naze Tairitsu Surunoka* [Zero Interest Rate – The BOJ vs. Government: Why Do They Confront Each Other?], Tokyo: Iwanami Shoten, 2004, p. 177.

[35] For example, see John Goodman, 'The Politics of Central Bank Independence', *Comparative Politics* 23, 3 (April, 1991): 329–49.

[36] Malcolm, *Financial Globalization*, pp. 94–101.

policy-making structures.[37] Another view, presented by Jennifer Holt Dwyer, contends that the BJL law was revised to establish credibility among domestic and foreign actors in order to stem the declining international competitiveness of Japan's financial markets. Central bank independence would serve as evidence that the government was serious about embracing international standards in the areas of finance and money and, more broadly, of reforming its policy-making structures to adapt to the new economic realities of globalization. With respect to the BOJ, a specific claim along these lines is that central bank independence was required to give credibility to the Japanese 'Big Bang' announced in 1996 and scheduled for completion in 2001. This set of financial deregulatory measures was designed to make the Tokyo market competitive with those of London and New York.

The *gaiatsu* view has little or no support. The three most obvious potential sources of external pressure – the United States, IMF, and OECD – did not push the Japanese government to grant the BOJ greater independence, though they viewed such reform favorably. In addition, significant changes in capital flows into and out of Japan did not occur in the period before the revision occurred.[38] Japanese banks and firms did face somewhat higher interest rates on their borrowing in this period due to lower credit ratings, but this trend was hardly sufficient to provoke a reform of central banking on this scale. Finally, the idea that Japan needed to change to conform to the international trend or standard had become a constant theme in Japanese discourse starting in the 1980s, yet the central bank law was untouched for almost two decades.

Undoubtedly, Japanese officials hoped that BOJ reform would give the impression that Japan was converging toward best practice and improving its policy-making structures. Further, increasing central bank independence added some credibility to the Japanese 'Big Bang' by creating the institutional framework that financial market participants generally believe contributes to a stable monetary environment (though monetary performance in Japan was superior to that of most countries with independent banks). Nonetheless, the areas of financial policy that mattered most to foreign intermediaries interested in establishing operations in Japan were the supervision, prudential regulation, and establishment of financial entities, issues that would fall to the newly created Financial Services Agency, not the central bank. Additionally, it was not lost on domestic or international actors that the revised BJL stopped short of granting the central bank the level of independence implied by international standards. In fact, politicians known as 'internationalists', including Ikeda Motohisa and Tanaka Koh, opposed the bill because they believed that certain

37 We are unaware of any scholarly work that argues that international pressure played a central role in the revision of the BJL. A typical *gaiatsu* argument applied to another area of Japanese economic policy (trade) is Leonard Schoppa, 'Two-Level Games and Bargaining Outcomes: Why Gaiatsu Succeeds in Japan in Some Cases but not Others', *International Organization* 47, 3 (Summer 1993): 353–86.

38 See the 'International Investment Position of Japan' and 'Foreign Direct Investment' sections of the Ministry of Finance Statistics <http://www.mof.go.jp/english/files.htm> (1 January 2005).

elements, such as the government's right to request a delay of Policy Board decisions, did not satisfy the 'global standard'.[39]

The new strategic environment of BOJ–government relations

Although the revised BJL increased the BOJ's independence, it was not intended to create a fully autonomous central bank, but rather to weaken the power of the MOF over the BOJ and augment the influence of politicians over monetary policy.[40] This section shows that, despite the changes in formal statutes, political interference in monetary policy actually intensified, undermining the legitimacy of the new legal framework. It also answers the question of whether lawmakers accomplished their aims by examining the new strategic relationship between politicians and the BOJ, as well as the course of monetary policy in the aftermath of the revision.

Gerald Curtis has argued that the informal institutions and processes involved in formulating and implementing public policy in Japan are as important as formal procedures and rules.[41] Political actors often use informal processes to circumvent the constraints of formal ones, and formal institutions to validate decisions made in the context of informal ones. Similarly, we suggest that politicians hoped to exercise influence over the BOJ through informal means and rely on the new BJL to legitimize and validate the resulting monetary policy as being the product of an independent, technocratic central bank. The informal channels were many: efforts to intimidate BOJ officials in private meetings and public fora; use of the media to pressure the BOJ to accede to government demands; and threats to revise the BJL again to establish greater political control over the Bank. In addition, politicians had legal means of influence: the power to appoint top BOJ officials; requiring Bank leadership to testify before the Diet; and invoking the 'harmony' clause between the government and the central bank. The first few years after the passage of the law would be critical. If politicians were able to establish *de facto* supervisory control over the BOJ, then this relationship would take hold and become the accepted way of conducting business.

To what extent did they succeed? We argue that the BOJ established a higher degree of independence than anyone expected. The politicians' plan to exert control through various formal and informal channels failed because they assumed incorrectly

39 See the 7 May and 21 May 1997 Lower House Diet proceedings on revising the BJL. Aside from Shiozaki Yasuhisa, a former BOJ official and member of the LDP Administrative Reform Promotion Headquarters who vocally promoted central bank reform, most of the politicians involved in revising the law were not known as internationalists. See Toya, *Kinyū Bigguban*, p. 189.

40 The new law increased the quantitative rating of central bank independence in Japan. Using the Cukierman, Webb, and Neyapti index, Cargill, Hutchinson, and Ito found that the BOJ's rating increased from 0.18 to 0.39. Thomas Cargill, Michael Hutchinson, and Takatoshi Ito, *Financial Policy and Central Banking in Japan*, Cambridge: MIT Press, 2000, p. 107. Takahashi Tomohiko, '*Kaisei Nichiginhō to Chūōginkō no Dokuritsusei*' [The Revised Bank of Japan Law and Central Bank Independence], *Public Choice Studies*, no. 34, Keisoshobo: Tokyo, 25 June 2000, reached a similar conclusion.

41 Gerald L. Curtis, *The Logic of Japanese Politics: Leaders, Institutions, and the Limits of Change*, New York: Columbia University Press, 1999, p. 4.

that the BOJ would bow to political pressure. Instead, top Bank officials, notably, its first governor, Hayami, recognized that the strategic environment had changed and the BOJ had acquired the means to conduct a truly independent policy. In the late 1990s, most actors favored aggressive monetary easing to address persistent deflation and slow growth. The BOJ, however, resisted this course and actually tightened policy at a critical juncture, provoking serious conflicts with the government. Through their statements and actions, officials signaled that they were prioritizing the goal of asserting BOJ autonomy, a common objective among newly independent central banks.

In their determination to show that they would not accede to the demands for looser policies or be subject to partisan control, BOJ officials probably overshot in the other direction, inflicting harm on the Japanese economy.[42] Nonetheless, during the Hayami era, the frequently confrontational nature of BOJ policy cannot be explained solely by the desire to establish independence alone. As Adam Posen first suggested and, as we amplify, it was also motivated by the wish to promote structural reform of the Japanese economy.[43] This policy of brinkmanship was reckless and ineffective and, thankfully, has not been followed by Fukui.

When politicians realized that their tactics were failing to invoke the desired response by the BOJ, they adopted new means of attempting to influence the central bank. Starting in 2001, some politicians proposed revising the BJL again to place the BOJ under stricter political control and supervision. This threat, so soon after passage of the law, was not entirely credible, especially given a lack of consensus among politicians. Yet, it did signal central bankers that lawmakers could alter the legal framework if they continued to disregard politicians' preferences or tried to expand the BOJ's influence into new areas. They also indicated that the appointment of the BOJ governor would henceforth be subject to a careful selection process in which cooperation with the government would figure prominently.

Creating a new Bank of Japan identity: 1998–2000

A month before the new BJL came into effect, BOJ governor Matsushita Yasuo resigned due to political pressure generated by the corruption scandal of Yoshizawa Yasuyuki, the head of the Capital Market Division of the BOJ's Credit and Market Management Department. The new governor, Hayami Masaru, was appointed on 20 March 1998. Hayami was a former career BOJ official with more than 30 years experience, had served as the president and chairman of Nissho Iwai Corporation for 17 years, and had headed the *Keizai Dōyūkai* (a business lobbying group) in the early 1990s.

42 See Bernanke, 'Japanese Monetary Policy' and Takatoshi Ito and Frederic S. Mishkin, 'Two Decades of Japanese Monetary Policy and the Deflation Problem' (Paper presented at NBER 15th East Asian Seminar on Economics, 25–27 June 2004), pp. 15–16. This charge has been leveled against the European Central Bank as well.

43 Adam Posen, 'The Political Economy of Deflationary Monetary Policy', in Ryoichi Mikitani and Adam Posen (eds), *Japan's Financial Crisis and Its Parallels to the US Experience*, Washington, DC: Institute for International Economics, 2000. See also Werner, *Princes*, chapter 14.

As in other countries with newly independent central banks, financial market participants adopted a wait-and-see approach to determine whether the BOJ had the capacity and will to design truly independent policies. Many observers were skeptical that the scandal-ridden BOJ would be ready to take advantage of its augmented formal independence.[44] Indeed, a former Policy Board member, Dr Shinotsuka Eiko, revealed that the BOJ faced many challenging administrative and economic issues immediately following the 1998 revision. Officials had to 'establish their own rules for the first time', such as Policy Board meeting procedures (e.g., order of speaking), and Board members had to educate themselves on various economic issues.[45] In addition, Karube Kensuke observed that many BOJ officials underwent a sort of identity crisis. Prior to the revision, the BOJ's identity was closely tied to the MOF but, with its newly gained autonomy from the Ministry, officials did not know what was expected of them or what it meant for the Bank to be 'truly independent'.[46] As we detail later, this question was partially answered by Hayami's strong character and vision for the new BOJ. Although the revision attempted to position the Diet and the BOJ in a closer relationship, in Hayami's mind, central bank independence could not be exercised unless it had an arms-length relationship with politicians.

It was widely believed that 'LDP politicians [would] abuse the revised Bank of Japan law to put pressure on the central bank', and, in fact, they wasted little time in doing so.[47] Under the new law, the BOJ was obligated to explain and justify its policies before the Diet on a regular basis, giving politicians a channel to influence central bank policies. The 'direct reporting' requirement was grossly misused from the start as Fujii Yoshihiro observed:

> Since taking office in March last year, Hayami has been called before parliamentary committees more than 130 times, a mind-boggling number when compared with similar claims on two of his foreign counterparts' time – about twenty times a year for US Federal Reserve Board Chairman Alan Greenspan and six to ten times a year for Governor Eddie George of the Bank of England.[48]

Even the Bank's first Policy Board meeting, no doubt a momentous occasion, was delayed because Hayami first had to report to the Diet.

In spite of the obstacles facing the BOJ, it sought to establish its independence and pursue an activist monetary policy. This can be seen in the highly public battle over money supply growth. Throughout 1998–99, the BOJ resisted intense pressure by the Japanese government, private markets, the United States and other G-7 nations, professional economists, and the IMF and OECD, all of which urged aggressive

44 Miyao, *Nihon Ginkō*, p. 117.

45 Bloomberg Japan Service, '*Shinotsukashi to Kaerimiru Shin Nichiginhō Sannen* (2)' [Looking Back at the First Three Years of the New Bank of Japan Law with Dr. Shinotsuka], 24 June 2001, pp. 1–5.

46 Karube, *Zero Kinri – Nichigin*, pp. 104–105.

47 *Asahi Shimbun*, 1 July 1999.

48 *Nikkei Weekly*, 18 October 1999.

monetary easing to curb the rise in the yen against the dollar, reverse deflation, and encourage economic growth. In addition, the BOJ rejected government requests to purchase public debt directly (instead of through open market operations) as the government grew more dependent on costly bond sales to finance the national budget deficit.

Asserting independence: 2000–02

On 11 August 2000, the BOJ stunned financial markets by raising the interbank rate on unsecured overnight call loans from practically zero to 25 basis points (while leaving the discount rate at 50 basis points). The bank stated that this move was necessary because signs of economic recovery were evident, in particular a gradual increase in corporate profits and fixed business investment. At the monetary policy meeting where this decision was taken, delegates from the MOF and Economic Planning Agency, pursuant to Section 2 of Article 19, requested the Policy Board to delay the vote on lifting the zero interest rate policy. The board, however, rejected the government's request and voted by 7–2 to increase the interbank rate.

This measure was controversial because monetary authorities had not increased interest rates since 1991 and the end of the 'zero rate policy' took place when the Japanese economy was still struggling with persistent deflation. It was unprecedented for the BOJ to ignore vehement opposition and specific government requests against raising the interest rate. Many politicians and economists viewed this decision as an intentional act of defiance by the BOJ against the government in order to add credibility to its newly gained independence. For instance, Kato Koichi, the former secretary general of the LDP, called it 'nothing but a political show'.[49]

Asserting its autonomy was fundamental, but top BOJ officials also hoped that tighter monetary policy would promote structural reform by highlighting problems in the economy and pushing the relevant actors to confront them.[50] This strategy, sometimes called 'liquidationism' by economic historians, is eerily reminiscent of that of US policy makers around the time of the 1929 stock market crash, a course of policy that helped to deepen the Great Depression.[51] Slow growth would force politicians as well as business and financial leaders to undertake restructuring that might be postponed

49 Interview with Kato Koichi, New York, NY, 11 November 2002.

50 See the minutes of the Policy Board meetings on 8 March and 24 March 2000 posted on the Bank's website: http://www.boj.or.jp/en/seisaku/05/seisak_f.htm. See also the numerous speeches that Hayami gave in 2000 arguing that an overly loose monetary policy might lead to a neglect or delay of structural reform. One example is 'The Role of Japan amid the Changing International Environment', Speech at the Meeting of the Executive Board of Directors of the Japan Foreign Trade Council, 7 June 2000 (available at www.boj.or.jp/en/press/press_f.html). Other BOJ officials made similar statements. For instance, see Masaaki Shirakawa, 'Monetary Policy under the Zero Interest Rate Constraint and Balance Sheet Adjustment', *International Finance* 4, 3 (Winter 2001): 463–90.

51 See Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939*, New York: Oxford University Press, 1995, pp. 249–53; and Milton Friedman and Anna Schwartz, *A Monetary History of the United States, 1867–1960*, Princeton, NJ: Princeton University Press, 1971, chapter 7.

indefinitely if the BOJ continued an easy money policy. The immediate result of a looser monetary policy might be an economic recovery, but it would perpetuate deep-rooted inefficiencies and distortions in the Japanese economy, hindering long-term growth.

At a time when many economists were urging experimentation to find new means of injecting additional liquidity into the economy, the BOJ's actions signaled to market participants that it believed that deflationary concerns had subsided. This deeply hurt the BOJ's credibility, indicating that it lacked the willingness or competence to help improve Japan's precarious economic situation. It further revealed that the BOJ had interpreted its mandate to include promoting structural reform, an area of policy which is normally not included in the objectives of central bankers because monetary policy is not thought of as a relevant instrument.[52] Throughout the previous two years, the BOJ had been urging the government, banks, and corporations to implement concrete and meaningful reform measures. Though the actual change in interest rates was minimal, the increase contributed to a decrease in the growth of broadly defined liquidity (from 3.1% in 2000 to 2.5% and 0.5% in 2001 and 2002, respectively), provoking a drop in prices (the GDP deflator fell by 1.3% and 1.5% in 2001 and 2002, respectively) and a serious recession starting in 2001 (nominal GDP growth in 2001 and 2002 was −2.4% and −0.7%, respectively).[53]

The BOJ cut overnight and discount rates in the spring of 2001 and instituted a policy of 'quantitative easing', in which it injected liquidity into the financial system by setting a target for the amount of surplus funds in the money market.[54] Still, it remained in defiance of the government in two ways. First, this move came long after the government's initial and subsequent requests, signaling that outside parties would not dictate policy to the BOJ. Second, the BOJ made it clear that further quantitative easing was conditional on the implementation of structural reform. Its overtly political approach was tantamount to a game of chicken: would the government have the nerve to continue postponing deep structural reforms and risk further deflation and recession due to a tight monetary policy? As we discuss later, the BOJ intensified this strategy of brinkmanship the following year when it tried to force the government to address banking system insolvency.

Frustrated by the BOJ's unexpected resistance to political pressure, some government officials stepped up their efforts to rein in the BOJ, attempting new tactics as well. In 2001, rumors began to circulate in the media that Hayami would step down early due to health reasons and to take responsibility for raising interest rates

52 Indeed, structural reform normally evolves out of a political decision-making process conducted by elected officials that are accountable to voters. The BOJ had no legal or political mandate to pursue structural reform and its leadership could not be held directly accountable for its policies.

53 Broadly defined liquidity includes the monetary stock plus other short-term assets. See 'Bank of Japan Statistics and Other Key Statistics' at http://www.boj.or.jp/en/stat/sk/ske.htm and 'Financial and Economic Studies Monthly' at http://www.boj.or.jp/stat/sk/data/sk4.pdf (1 July 2005).

54 For a technical discussion of the quantitative easing policy, see Eiji Maeda, Bunya Fujiwara, Aiko Mineshima, and Ken Taniguchi, 'Japan's Open Market Operations under the Quantitative Easing Policy', Bank of Japan Working Paper No. 05-E-3 (April 2005).

prematurely. BOJ officials quickly denounced the MOF and politicians 'for leaking the resignation tale' to the media.[55] Hayami publicly denied the rumors of an early resignation, insisted that the Bank's autonomy should be respected, and continued to speak out forcefully when the BOJ was criticized.

More significantly, some members of the tripartite ruling coalition proposed revising the BJL again to restrict the BOJ's autonomy. On 9 August 2001, a group of LDP lawmakers, asserting that new BJL had created an excessively independent central bank, announced that they would submit a bill to secure more reliable channels to exercise political influence on the BOJ.[56] Led by the LDP's Yamamoto Kozo and Masuzoe Yoichi, they proposed revising Article 15 to require the BOJ to set an inflation target in consultation with other economic ministries. Inflation targeting was a monetary policy approach increasingly favored by economists but fiercely opposed by Hayami, who viewed it as a blatant effort to curtail BOJ autonomy.[57] They also sought to strengthen Article 4 in order to increase the level of harmonization between BOJ and government policies. Though opposition from other lawmakers, including new Prime Minister Koizumi, blocked this initiative, the movement to revise central bank legislation was potent and resurfaced in subsequent years.

Promoting structural reform: 2002–03

In September 2002, the BOJ announced that it would begin purchasing $24 billion worth of equity held by major Japanese banks in order to improve their balance sheets and enable them to dispose of the non-performing loans (NPL) in their portfolios more aggressively. This measure was highly controversial and unusual; no developed country central bank had intervened in the banking system in this way since the Second World War.

The initiative was aimed at reducing the risk to Japanese banks of unwinding cross-held shares; the purchases were limited to stocks that banks held in excess of a level determined by their paid-in capital. By highlighting the severity of the banking crisis, this measure challenged banks and, more importantly, the government to address the issue of bank system insolvency more energetically. Up to that point, policy makers had failed miserably in restoring confidence in the banking system, fueling intense criticism both domestically and abroad. The BOJ's action suggested that the banking crisis had reached a new level of severity and it led to demands that the government and banks match the BOJ's bold action with complementary policies. The ability of

55 *Financial Times*, 3 May 2001.

56 See the draft proposal to revise the BJL at 'Revising the BOJ Law' (September 2001) at <http://www.mizuho-sc.com/english/ebond/boj/bojlaw.html> (accessed: 1 July 2004).

57 Prominent Japanese economists, such as Ito Takatoshi, Yoshikawa Hiroshi, and Ito Motoshige, have argued in favor of inflation targeting. On inflation targeting generally, see Ben Bernanke, Thomas Laubach, Frederic Mishkin, and Adam Posen, *Inflation Targeting: Lessons from the International Experience*, Princeton, NJ: Princeton University Press, 1999. For an argument supporting inflation targeting in the Japanese case, see Bernanke, '*Japanese Monetary Policy*'.

Bank officials to pressure banks, the government, and bureaucracy effectively indicated that the BOJ had acquired more autonomy than anyone had anticipated; certainly, this type of intervention would have been inconceivable before the BJL revision. In fact, the action led to the public humiliation and quick firing of Yanagisawa Hakuo, the Minister for Financial Services, who had resisted a previous BOJ proposal to inject public money into banks and effectively nationalize them.[58]

The threat to revise the BJL resurfaced in 2002, this time advanced by influential conservative LDP politician, Aizawa Hideyuki. Aizawa proposed empowering the Cabinet to fire the BOJ governor and requiring the Bank to set and meet an inflation target. To augment the BOJ's ability to add liquidity through open market operations, he also wanted to permit the Bank to purchase a broader range of assets when it intervened. Aizawa's political stature increased the significance of this proposal, making all relevant actors take note of the stakes involved.

In addition, government pressure on the BOJ to change its monetary policy intensified during the last few months of Hayami's term. Prime Minister Koizumi and various ministers, including Takenaka Heizo of Economy and Financial Services, joined voices to urge the BOJ to reach a policy accord with the government to overcome deflation through inflation targeting. This was a contrast to 2001 when the LDP coalition was sharply divided on this issue. Koizumi, for instance, had never been an avid supporter of inflation targeting. He adopted a pro-inflation targeting stance at this juncture, primarily to augment pressure on Hayami. Knowing that such an accord would bind the central bank to a concrete inflation target, Hayami rejected it and stated bluntly that the BOJ decides monetary policy at its Policy Board meetings, not in consultation with the government. Realizing that further attempts to influence Hayami were futile, Koizumi and other political leaders turned their attention to the appointment of the next governor as a means of increasing their influence over the BOJ.

The BOJ under Fukui Toshihiko: 2003–06

When Hayami's five-year term expired in March 2003, Koizumi appointed Fukui Toshihiko, the chairman of the Fujitsu Research Institute and former deputy governor of the BOJ under governor Matsushita. Other private sector candidates, such as Imai Takashi, the former chairman of the *Keidanren*, and Nakahara Nobuyuki, the former head of Tonen Energy, were considered but did not gain broad backing from politicians, bureaucrats, and business leaders. On the other hand, Fukui, with his 40 years of experience at the BOJ and close ties with government officials, enjoyed a wide range of support from politicians, including the Chief Cabinet Secretary, Fukuda Yasuo. Most significantly, influential former Prime Minister Miyazawa personally lobbied Koizumi to appoint Fukui. On 21 January 2003, Miyazawa met with Koizumi to express his opposition to inflation targeting and his strong support for Fukui, who was on record

58 Werner, *Princes*, p. 206.

against this strategy. The rare visit by Miyazawa, who had a reputation as an astute LDP economic policy advisor, closed the deal for Fukui.[59] In addition, Koizumi perceived Fukui as more flexible and willing to cooperate than his predecessor.[60]

Nonetheless, the first months of Fukui's tenure saw a continuation of intense pressure on the BOJ, as politicians showed that they remained poised for battle over monetary policy. In April 2003, the threat to revise the BJL emerged yet again. Aizawa demanded that Fukui make the BOJ's position on inflation targeting clear and warned that if the Bank did not initiate this strategy, he would submit a bill to modify the BJL.[61] Fukui's response was diplomatic. He assured Aizawa that he was not against inflation targeting per se, but believed that the policy was inappropriate at the moment. Pleasantly surprised, Aizawa commended Fukui's cooperative stance and toned down his criticism of the central bank.

For his part, Fukui realized that past BOJ policy, notably, its brinkmanship with interest rates during 2000–01, was damaging to the Japanese economy and the central bank's credibility. Freed from the necessity of establishing BOJ autonomy through head-on confrontation, he adopted a more conciliatory tone and prioritized developing more effective policies.[62] Fukui swiftly organized his policy board and moved to inject much more liquidity into the market through the quantitative easing policy, both to boost economic growth and revive a fragile banking system. For instance, the BOJ supplied extra liquidity to assist banks with NPL problems (e.g., increasing share purchases from private banks from one to three trillion yen) and bought asset-backed securities to give failing firms time to restructure. As a result, broadly defined liquidity increased by 0.6% and 3.1% in 2003 and 2004, respectively. In addition, Fukui, correctly recognizing that cooperation with other state agencies did not necessarily mean subordination of the BOJ to political influence, agreed to meet with government officials five times a year to discuss how the BOJ and key ministries might coordinate their policies more effectively.

Given the BOJ's monetary strategy, which has been more in line with government preferences, Fukui's more cooperative tone, and Japan's improving economic outlook, politicians have not pressured the central bank with the same intensity as during the Hayami era. It has helped that some analysts believe that the BOJ's monetary policy under Fukui has contributed to the recovery. Nevertheless, the Bank is now facing policy choices that may spark confrontations with the government. Economic recovery is underway and prices finally seem poised to rise. Consequently, the BOJ ended the quantitative easing policy in March 2006 and has hinted that the reversal of the zero-interest policy is likely soon. Raising rates could dampen economic growth and might

[59] *Nikkei*, 17 March 2003.

[60] Richard Katz, 'The Case for Fukui', *The International Economy* 17, 2 (Spring 2003): 46.

[61] 156th Lower House Financial Committee, 18 April 2003.

[62] For a detailed description of Governor Fukui's record from 2003 to 2004, see Shimizu Isaya, *Nichigin wa Kōshite Kinyū Seisaku wo Kimeteiru* [This is How the Bank of Japan is Deciding Monetary Policy], Tokyo: Nihon Keizai Shimbunsha, 2004, pp. 18–72.

contribute to a decline in bond prices, which would increase the cost of government borrowing, hurt the balance sheet of banks (which have accumulated huge sums of Japanese government bonds recently), and intensify pressure on poorly performing firms. The LDP-led government has vehemently protested against any interest rate hike and pleaded with Fukui to maintain a loose monetary policy. Some lawmakers, including LDP policy chief, Nakagawa Hidenao have again warned that, if the BOJ does not cooperate with policy makers, they will consider revising the BJL. Despite the heightened tension between the central bank and government, we believe that BOJ autonomy is sufficiently well established that renewed political pressure is unlikely to have any significant effect on institutional arrangements.

Why did the BOJ prevail?

The Diet revised the BJL to shift control over the central bank away from the MOF and increase its own influence. It succeeded in reducing the MOF's authority but not in augmenting its own. The BOJ resisted political interference and adopted monetary policies that were frequently to the government's intense disliking. What factors contributed to the BOJ's ability to take advantage of the new strategic environment and assert its autonomy so unexpectedly? This paper identifies three variables that played a major role. These factors helped to shift the direction of central bank institutional change away from its intended path in unanticipated ways. Our analysis of these variables also underscores the importance of non-statutory factors in influencing the *de facto* degree of central bank independence.

Factor 1. Individual leadership: Governor Hayami Masaru

Governor Hayami took office determined to safeguard the BOJ's newly won independence, though this was not fully appreciated by anyone at the time. As he later acknowledged, his mission to insulate the BOJ from political pressure took on religious overtones.[63] Hayami was appointed largely because he was seen as untarnished by the many scandals surrounding financial policy makers and able to bring an improved image to the newly reformed BOJ.[64] Furthermore, politicians thought that he was unlikely to take strong, critical positions and could be 'easily swayed' by political pressure.[65] Hayami had sometimes criticized government policy in the past (e.g., exchange rate policy in 1993) but usually withdrew his comments when politicians challenged him in response.[66]

[63] Hayami believed that his task to safeguard the BOJ's autonomy was 'God's calling' (*Kami no shōmei*). See Hayami Masaru, *Chūō Ginkō no Dokuritsusei to Kinyū Seisaku* [Central Bank Independence and Monetary Policy], Tokyo: Tōyō Keizai Shinpōsha, 2004, p. iv; and Bank of Japan, *Hayami sousai tainin kishakaiken youshi* [Governor Hayami's farewell speech], 19 March 2003 at http://www.boj.or.jp/press/03/kk0303b.htm, pp. 1–13 (accessed: 1 April 2005).

[64] Wright, *Japan's Fiscal Crisis*, p. 182.

[65] *The Economist*, 21 March 1998.

[66] Andrew Horvat, 'Will Hayami Stop the Banks Being Roasted?', *Euromoney*, 348 (April 1998): 12.

Hayami's leadership of the BOJ proved a bitter surprise for politicians and, unable to fire Hayami, they paid a hefty price for their miscalculation. During Hayami's five year tenure, the BOJ designed policies that frequently conflicted with the government's preferences. As discussed, some lawmakers tried to contain Hayami by threatening to revise the BJL and abolish his job guarantee, but this tactic failed. In contrast, past governors, like Matsushita Yasuo, had folded easily when confronted with government pressure. In the Japanese cultural context, Hayami's completion of his term is remarkable given that the country's fixation on 'shame' (*haji no bunka*) has often forced political and business leaders to resign when faced with controversy or undesirable outcomes. Hayami broke with tradition by disregarding calls for his early resignation due to questionable decision making and the poor performance of the Japanese economy.

Hayami's resolve was critical to building an autonomous BOJ unafraid of contesting other economic actors. The strategic environment created by the revised BJL supplied incentives for the BOJ to assert its independence, but taking advantage of this required a first post-reform governor who would not be intimidated or retreat from confrontation; a governor with different personality traits might have led to a different outcome. This claim is consistent with James Q. Wilson's finding that the initial leaders of new or recently reformed agencies greatly influence how they define their mission.[67] For those who believe that Hayami's actions harmed the Japanese economy, it also calls to mind Milton Friedman's observation that a primary argument against central bank independence is that it 'makes important policy actions highly dependent on accidents of personality'.[68] In Japan, the 'accident' of Hayami's personality profoundly shaped the development of post-reform central banking and monetary policy choices.

Factor 2. Exploiting politicization of central banking

Government efforts to establish political control over central banking had an unanticipated consequence: it encouraged BOJ officials to become overtly political actors and created new means by which they could pursue their objectives. The Japanese economic and political situation at the time limited the ability of politicians to exercise control, providing a window of opportunity for central bankers. The literature on institutional change emphasizes the role of a nation's political and economic conditions (especially the incidence of crisis) in bringing about reform, but it has much less to say on how they influence its post-reform evolution. Our findings here suggest that this topic merits closer attention.

First, frequent Diet reporting caused BOJ officials to adopt a political as well as economic calculus in their decision making, since they were forced to sell their policies to Diet members and the public. The excessive number of demands to testify before

[67] James Q. Wilson, *Bureaucracy: What Government Agencies Do and Why They Do it*, New York: Basic Books, 1989.

[68] Milton Friedman, *Capitalism and Freedom*, Chicago: University of Chicago Press, 1963, p. 50.

the Diet – an incredible 388 times during Hayami's tenure – convinced them that they were involved in a high stakes political game and only strengthened their resolve to increase their autonomy. Of course, the opposite could have happened: this tactic might have convinced central bankers that lawmakers could rewrite the rules and force compliance if they became overly dissatisfied with the BOJ's actions. This is precisely what Diet officials intended when they adopted this strategy. This response did not occur in part because of the interactive effects of Hayami's strong leadership. Hayami was determined to resist political demands and create a truly independent central bank, even if this meant sacrificing its short-term credibility as a sound policy-making institution.

Second, the enhanced transparency of the monetary policy-making process after the revision enabled top BOJ officials to use the media to pursue their objectives, even as the government sought to employ the press to browbeat the Bank. Once it had complied with the legal obligation to publish the proceedings of certain regularly scheduled meetings, the BOJ could have opted not to explain its plans in detail, following the practice of many central banks. Instead, it actively exploited the media to generate support for its policies and independent status. Hayami, for instance, held nearly one hundred press conferences during his tenure in office, often using them to denounce government interference in monetary policy making.

Paradoxically, the LDP coalition attempted to establish political control over the central bank at a time when it was unlikely to succeed. Political uncertainty, numerous scandals, and signs of LDP disarray marked the years following the passage of the new BJL. The strong divisions among leading politicians and public dissatisfaction with the government created a political space that could be filled by a central bank intent on becoming a major player in Japanese political economy. The difficulties in controlling the BOJ were exacerbated by the prolonged economic recession, since blame for the economic situation fell largely on elected officials, not the BOJ. The government's failure to provide a concrete plan to strengthen the economy made its criticism of the BOJ less effective.

In this regard, the transformation of central banking in the United States during the Great Depression provides a stark contrast to the Japanese case. When Franklin Roosevelt took office at the height of the Great Depression, the 'clarity of the change in policy was unmistakable'.[69] The Roosevelt administration implemented a series of bold measures such as the Bank Holiday, a major devaluation of the dollar, and the innovative set of policies associated with the New Deal. The Fed had implemented a policy of liquidationism after the Stock Market crash of 1929 and had been slow to increase the money supply afterwards, but it adopted a more accommodating monetary policy in line with and in response to Roosevelt's daring vision. In contrast, when Koizumi took office in 2001 he did not have a concrete economic strategy for reviving the moribund Japanese economy. Consequently, Hayami had little incentive to cooperate and modify

[69] Peter Temin, *Lessons from the Great Depression*, Cambridge, MA: The MIT Press, 1990, p. 96.

the BOJ's monetary policy. In the end, the harmonization of government and BOJ policy sought by Article 4 of the revised BJL was never achieved precisely when it was most needed to aid the ailing Japanese economy.

Factor 3. Knowledge as influence: building research capacity at the BOJ

Traditionally, most government officials shared similar views on economic matters because the MOF supplied the bulk of data and analysis. Starting in the early 1990s, the BOJ attempted to gain autonomy and influence without going through legal channels by adopting 'a flanking strategy that involve(d) turning information into regulatory and policy-making power', which would allow it to surpass the 'Ministry of Finance in the breadth and quality of information that it gathers on Japanese commercial banks and securities houses at home and abroad'.[70] This tactical approach was not surprising because the BOJ had been doing some of its own research for decades, notably, publishing a business survey called the *Tankan* and the *Kinyū Keizai Geppō* (Monthly Report of Recent Economic and Financial Developments).

In an effort to strengthen its post-reform independence, the BOJ intensified this strategy by increasing its publication and research activities as well as their dissemination. The *Keizai Bukka Jōsei no Tenbō* (Outlook for Economic Activity and Prices), Market Review E-Series, and various discussion, working, and issue papers are now readily available.[71] Ascertaining whether the BOJ's research and publication budget has increased is difficult, since the Bank implemented many administrative changes and streamlined its budget after the BJL revision to improve its efficiency; in addition, research activities take place at several organizational levels across different divisions. Nonetheless, BOJ officials that we have interviewed generally confirm that spending on research and data collection has grown and the Bank's capacity to develop independent viewpoints is greatly enhanced in the post-revision era.

The value of having an augmented research capacity became evident when the BOJ announced its unpopular interest rate hike in 2000. At the time, the MOF and the Financial Services Agency forecasted that the economy was still recovering, implying that the BOJ should maintain the zero interest rate policy. The BOJ, on the other hand, published its own, far more upbeat economic projections, insisting that the economy could absorb its course of monetary tightening. This forecast helped deflect, at least momentarily, the sharp criticism directed at its policy decision. In another issue area, the BOJ undertook its own study of NPL, estimating the level to be far greater than the figures published by the government. This independent analysis of NPL problems was

70 Naoyuki Isono, 'BOJ Reorganization Viewed as MOF Curb', *Japan Economic Journal* 5 (May 1990): 26.

71 For descriptions of the BOJ's current research and publications, see Institute for Monetary and Economic Studies, Bank of Japan, *Atarashii Nippon Ginkō Sono Kinō to Gyōmu* [The New Bank of Japan: Its Functions and Operations], Tokyo: Yuhikaku, 2004, pp. 157–75.

instrumental in the BOJ's efforts to pressure the government to adopt bolder measures to resolve the crisis.

Conclusion and implications

The BJL revision was never intended to create a fully autonomous central bank insulated from political forces, but rather was an attempt by politicians to weaken the authority of the MOF over the BOJ and augment their own. Domestic political changes in the 1990s – the demise of LDP hegemony, changes in the relationship between politicians and the bureaucracy, and public demand for greater accountability of policy makers – were the motivating factors behind reform of the central bank system. This finding indicates that reforms of national economic structures, even those with a direct interface with the international system, like central banking, are not necessarily motivated by globalization; domestic politics continue to be a potent force behind institutional change. In the Japanese case, domestic factors had the primary role in promoting central bank reform initially and were also the most important in determining the course of post-enactment institutional evolution.

The new BJL granted the BOJ more formal independence than before, but government officials hoped to rely on a variety of legal and informal means to shape monetary policy. The Bank, however, attained more autonomy than political leaders intended, enabling it to pursue a monetary policy that brought it into frequent confrontation with the government. Three factors were central to its success in achieving *de facto* independence: the leadership of governor Hayami Masaru; the Bank's ability to turn politicization of the policy-making process to its advantage; and the BOJ's strategy of building its research capacity to use expertise as a means of influence. The significance of these factors demonstrates that central bank independence, or lack thereof, is not solely derived from formal rules; non-statutory variables are equally important.

More generally, our results suggest that the reform of economic institutions is a complex, non-linear, and open-ended process. A new legal framework, even when backed by considerable consensus, only marks the completion of one phase of institutional change. In fact, the post-enactment stage may prove to be every bit as important, if not more so, than the pre-enactment period in determining final outcomes. As Robert Jervis has asserted, 'initial policies, no matter how well designed, rarely can be definitive; solutions will generate unexpected difficulties'.[72] The variables that influenced the post-enactment phase in our case are operative in many contexts, suggesting that the non-linearity of institutional reform or unanticipated results are not unique to either Japan or central banking and that scholars should pay more attention to leadership and informal factors in their analyses.

On the policy front, it remains to be determined whether greater central bank independence in Japan has led or will lead to superior monetary policy. The evidence in this paper suggests that it resulted in inferior policy during certain periods, a finding

72 Jervis, *System Effects*, p. 294.

that is at odds with studies that claim autonomous central banks perform better.[73] Indeed, in most countries, the principle most often cited by reformers for granting the central bank greater independence is achieving superior performance. Almost a decade has passed since the BOJ gained more autonomy, making it possible to begin to assess this issue.

73 Though some authors do not find a significant positive relationship between independence and monetary performance (measured as price stability) or growth in gross domestic product, most studies conclude that independent central banks provide superior results. Two important works are: Alberto Alesina and Lawrence H. Summers, 'Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence', *Journal of Money, Credit and Banking* (May 1993), pp. 151–62; and Cukierman, Webb, and Neyapti, 'Measuring Independence'.