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The Bank of Japan Experience: New Management and Lessons for Legal Central Bank Independence [1]

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Abstract: The concept of central bank independence is more complex and less useful than is generally presented in the extensive literature measuring independence and estimating correlations between policy outcomes and independence. The conventional wisdom is that institutional independence is important for the performance of monetary policy. The Bank of Japan is a central case study in this discussion, not only because it is an important and influential central bank that has drawn world attention, but because it provides a natural experiment to illustrate the wide distance between the simple conventional wisdom and the far more complex reality of contemporary central banking. Institutional independence is more myth than reality, does not generate the conventional wisdom's claimed monetary policy outcomes and diverts attention from establishing an institutional framework focused on a rules-based tactical and strategic framework to hold central banks accountable for what they can accomplish - price stability.

Keywords: Central Bank Independence, Index of Central Bank Independence, Bank of Japan, Central Bank Management and Japan

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1. Introduction

Although the Bank of Japan was given legal independence in 1997, the radical shift in policy that accompanied the appointment of a new management team in early 2013 highlights the need for a reexamination of both the meaning and the consequences of central bank independence. Specifically, the Bank of Japan came under new management on March 19, 2013 when Governor Haruhiko Kuroda and Deputy Governors Kikuo Iwata and Hiroshi Nakaso assumed responsibility for Bank of Japan policy. The appointment of a new management team was not in itself remarkable, but the adoption thereafter of monetary policies that closely reflected politicians' demands was remarkable**.** Leading up to the December 12, 2012 Lower House elections returning Shinzo Abe to power, both the Democratic Party of Japan and the Liberal Democratic Party explicitly pressured

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the legally independent Bank of Japan to take a more activist role in ending Japan's decade-plus long deflation and both threatened to revise the 1997 Bank of Japan Law that had granted meaningful *de jure* independence to the Bank of Japan.

In stark contrast to the previous management, the new management team promised to follow the government's lead and do whatever is necessary to increase Japan's inflation rate up to 2% as part of the Abe government's "three-arrows" approach (monetary, fiscal and structural policy) to ending deflation, restoring growth and reducing the fiscal deficit in Japan.[2] Japan's monetary base increased 64 percent from March 2013 to September 2014; however, the slowdown in Japan's economy partly caused by the increase in the consumption tax in April 2014 convinced the government to double down on monetary policy. On October 31, 2014 the Bank of Japan announced it would greatly expand purchases of government bonds as well as smaller amounts of equity exchange-traded funds and real investment trust funds. The Bank of Japan refers to its quantitative easing policy (QEP) as QQE for "quantitative and qualitative easing", but the difference between QEP and QQE is a difference without much distinction as both policies significantly increase the monetary base while at the same time maintaining a zero-interest rate policy (ZIRP).

This substantial shift in policy and management was met with mixed reactions, but virtually all observers interpreted the change as a significant decline in the *de facto* independence the central bank had achieved *de jure* in 1997. Some argued the government *should* determine monetary policy and that the Bank of Japan's independence only enabled the previous management to pursue the wrong policies for too long (Hamada, 2009). Others argued that the new management's willingness to accept the government's setting of the target inflation rate was troubling in that it may permit Japan's politicians to pursue continued debt monetization (Hinge and Carlyle, 2013) and avoid the regulatory and structural reforms viewed as both long overdue and necessary for meaningful growth going forward.

Both, however, reflect a narrow view of central bank independence based on the conventional wisdom that institutional design is important for monetary policy outcomes. This paper finds the conventional wisdom wanting and uses the Bank of Japan and its recent management change as a natural experiment to illustrate the limitations of the conventional wisdom. Some will argue this paper sets up a false premise because central banks are obviously not independent from government, but can be institutionalized to be independent within government. This paper recognizes the distinction, but argues that the ability to design a central bank to be independent within government is difficult at best and too much importance has been given this perspective of independence. A review of the statistical evidence combined with the review of Bank of Japan monetary policy suggests at best only weak support for the conventional wisdom that *de jure* independent (within government) central banks generate better inflation policy outcomes.

2. *De jure* Independence: Challenging the Conventional Wisdom

The institutional design of the central bank was not important under the gold standard and eligibility rules for discounting because price stability would be achieved by automatic inflows and outflows of gold. The evolution of a fiduciary monetary system and discretionary monetary policy,

2 Japan is the only industrialized economy since the Great Depression of the 1930s to experience prolonged deflation starting in 1995 and although not extreme, this prolonged deflation is widely regarded as a significant factor contributing to Japan's economic and financial malaise.

however, elevated institutional design as a potential solution to the conflict between government incentives to use monetary policy for short-term political purposes and the need to stabilize the value of the nation's money supply. Specifically, central bank independence was viewed as the best means to ensure that this conflict did not result in excessive monetary growth and inflation. In addition, the establishment of a *de jure* independent Federal Reserve in 1913 and the 1951 Treasury-Federal Reserve Accord played a major role in the emergence of the conventional wisdom that independent central banks generate lower inflation outcomes than do dependent central banks (Cargill and O'Driscoll, 2013). Much of this conventional wisdom was antidotal and based on the price stability period of the Federal Reserve in the 1950s after the Treasury-Federal Reserve Accord, but as emphasized in Meltzer's history of the Federal Reserve the 1950s (2009) cannot be used to relate price stability with Federal Reserve independence as the Federal Reserve was under no pressure from government since government deficits were small and the government was not activist in terms of macroeconomic policy. There was no detailed empirical evidence that supported the conventional wisdom.

This changed in the 1980s and 1990s as researchers developed measures of central bank independence and estimated correlations between inflation and the measures over time and across countries. This research agenda was first proposed by Bade and Parkin[3] (1982), extended by Cukierman (1992), and Cukierman, Webb and Neyapti (1992), and has evolved into a substantial body of literature claiming there exists a statistically significant inverse relationship between inflation and measures of central bank independence. Alesina and Summers (1993) and Carlstrom and Fuerst (2009) are typical of the importance given to the measures and correlations based on the measures. Klomp and de Haan (2010) provide perhaps the most extensive investigation to date. They combined 59 studies in a meta-regression analysis and concluded there is a negative and significant relationship between inflation and central bank independence for OECD countries.

The broad acceptance and influence of the institutional independence and associated measurement literature cannot be overstated; the independence perspective is embraced by a variety of government institutions, economists, the news media, financial market participants, textbooks, and much of the public. Yet, much of the central bank independence literature has overstated the empirical support and as a result, the institutional redesign of central banks during the past three decades has been based on flawed statistical evidence. Specifically, the methodological and statistical foundation of the widely accepted inverse correlations between measures of central bank independence and inflation outcomes are spurious and therefore fundamentally flawed on close inspection (Cargill 2013). A number of researchers question the entire framework of measuring independence based on the formal relationship between the central bank and government as well as the statistical results and conclude they provide misinformation about the fundamental relationship between the central bank and government. They emphasize the low predictive power of the estimated relationship for the US and Japan (Cargill 1989); the difficulty of developing a cardinal index of independence required for regression analysis (Cargill 2013 and Parkin 2013); the lack of correlation between a *de jure* measure and the more relevant *de facto* measure of independence (Meltzer, 2003 and 2009; Alpana and Honig, 2010; and, Cargill 2013; Cargill, Hutchison and Ito, 2000); the lack of statistical robustness of the relationship between inflation and independence (Cargill, 2013; Fujiki, 1996; Campillo and Miron, 1997; and, Oatley, 1999); and, the direction of causation between inflation outcomes and *de jure* independence (Hayo and Hefeker, 2007 and 2010; Posen, 1998). Even those such as Pollard (1993) who are less critical of the measures of central bank independence express caution in the correlations based on the measures.

According to Cargill (2013), a close review of the measures, the failure of the measures to

[3] Despite being frequently cited the 1982 paper is not published and generally unavailable. A 1988 version of the 1982 paper is available at http://economics.uwo.ca/faculty/parkin/.

distinguish between *de jure* and *de facto* independence, the errors present in some of the measures, and the lack of robustness of the statistical results, suggest the measurement literature is not convincing. The measures cannot reasonably be used as cardinal measures of central bank independence in even a simple econometric framework, though they have some use indicating major institutional redesigns of a central bank such as the Bank of Japan pre and post-1997. It is difficult to understand the widespread acceptance of the measures and the simple statistical correlations in the context of current standards of econometric analysis.

The Bank of Japan experience combined with the flawed and misdirected measurement literature, has much to offer concerning the practice and consequences of central bank independence. By examining some of the more qualitative characteristics of central bank history in Japan we hope to highlight aspects often ignored or overlooked in the general literature on central bank independence. In particular, we highlight two lessons suggested by this history: that central banks are rarely consistently independent or even as independent as often claimed, and that institutional design is not as important for price stability as is generally assumed. Thus, while some have recently lamented the perceived decline in central bank independence as "paradise lost", we consider it "paradise never found".[4] In short, the Bank of Japan case offers two important reasons to reconsider the utility of the conventional wisdom regarding central bank independence.

First, Bank of Japan postwar history, especially in comparison with the postwar history of the Federal Reserve, contradicts the conventional wisdom that independence explains monetary policy outcomes. While some have down-played the Japan case as an aberration or more often, simply ignored Japan, Japan's experience provides important insights into the limits to understanding of the policy consequences of central bank independence.

Second, Bank of Japan postwar history, especially in the last decade, illustrates the varying degrees to which central banks are responsive to their broader political conditions and constraints. Consequently, monetary policy is never as insulated from the political environment as the language or measures of central bank independence tend to suggest. Many claim they understand the political economy environment of central bank policy, but the reliance on the widely accepted correlations between measures of central bank independence and policy outcomes suggests this issue is given insufficient attention in designing new or redesigning existing central bank institutions [5].

[4] The reference of Milton's Paradise Lost in regard to central bank policy appears to have been first used by Issing (2012), but "paradise never found" we think is original with this paper.

[5] The focus of this paper is on Japan; however, the case of the Federal Reserve is instructive to illustrate how a central bank, even one ranked as one of the most independent in the world, is strongly sensitive to its political environment and conducts policy accordingly. The political sensitivity of the Federal Reserve is well documented in Meltzer's (2003 and 2009) history of the Federal Reserve and more recently by Cargill and O'Driscoll (2013), especially in their review of the Arthur Burns (1971-1978) and Alan Greenspan (1987-2006) administration of the Federal Reserve. As just one example, according to the *New York Times* (Chan and Dash, 2010), in former Chairman Greenspan's April 7, 2010 testimony to the Financial Crisis Commission "He [Greenspan] argued that if the Federal Reserve had tried to slow the housing market amid a 'fairly broad consensus' about encouraging homeownership, 'the would have clamped down on us'". The *New York Times* reference no longer includes the Greenspan quote; however, see *PBS Newshour* (Gustafson, 2010) and the *Oregonian* (Frank, 2010). Lacker and Weinberg (2014), two Federal Reserve economist, also indicate the political sensitivity of the Federal Reserve to housing.

3. Bank of Japan Policy Outcomes, *De Jure* and *De Facto* Independence

The postwar history of the Bank of Japan is not only quite interesting in its own right, it also usefully draws our attention to some underappreciated limits of the conventional wisdom and the possible over-emphasis on *de jure* independence as a means to achieve stable prices. The postwar history detailed below is bifurcated by the 1997 Bank of Japan Law.

The 1950 to 1997 Period: The macroeconomic performance of Japan since the end of WWII is remarkable, but during the period from 1950 up to the late 1980s with the exception of the early 1970s, the Bank of Japan achieved a price stability record that attracted world attention by the 1980s.[6] The experience of the Bank of Japan during this period has always challenged the conventional wisdom and illustrates that our understanding of the conditions under which central banks can best achieve price stability needs to extend beyond focusing on the institution's legal parameters to consider the broader political and economic circumstances that influence central bank behavior. Although modeled on the National Bank of Belgium, which was largely independent from the King, the Bank of Japan was established in 1882 as formally dependent and under the direction of the Ministry of Finance from the outset. This relationship remained virtually unchanged with a few modifications until 1997 when the Bank of Japan Law was revised to significantly increase the *de jure* independence of the Bank of Japan effective, April 1, 1998. Until the new law took effect in 1998, the Bank of Japan was considered one of the most legally dependent central banks in the world, measured at just 0.18 on a scale of 0 to 1 (Cukierman, Webb and Neyapti 1992, p. 392).

Yet in the post WWII period, this very legally dependent central bank produced one of the most successful price stabilization records of all the advanced industrial economies (Lohmann 1997, 64-65), especially in comparison to the one of the world's more independent central banks - the Federal Reserve (Cargill, 1989). With the exception of the years 1946, 1947 and 1948, when the Bank of Japan monetized government bonds and contributed to rampant inflation and the early 1970s when the Bank of Japan used monetary policy to continue high real GDP growth and then limit yen appreciation, the Bank of Japan presided over inflation and growth rates far superior to those of most independent central banks (Walsh, 1997, 90). Because of its record of successfully managing the spike of inflation in the early 1970s and achieving low inflation throughout the 1980s, when many advanced industrial economies were struggling with high inflation and stagnate growth, the Bank of Japan started attracting international attention to the so-called "Japan puzzle" – namely how such a dependent central bank produced such outstanding price stability outcomes. In 1996 *The Economist* summarized the Bank of Japan's record of maintaining price stability as "second to none" and many economists regarded the Bank of Japan as a "model" central bank for price stability (e.g., Hutchison, 1987). Clearly, the Bank of Japan's lack of *de jure* independence prior to 1998 did not prevent it from achieving a noteworthy record of price stability.

The pre-1998 performance of the Bank of Japan also illustrates that *de jure* dependence does not rule out some degree of *de facto* independence or price stability and that the range of autonomy given a central bank is always a function of not only agreement between the government and the central bank regarding goals, but also the central bank's credibility and reputation for achieving those goals. Bank of Japan history suggests that institutional independence itself is not a meaningful predictor of monetary policy performance. More compelling than simple independence are sets of explanations all resting on the general premise that *de facto* independence and price stability are endogenously determined by a third set of political, economic or cultural factors.

[6] Bank of Japan policy in the postwar period is discussed in Cargill, et al. (1997 and 2000) and Cargill and Sakamoto (2008) which contain references to extensive literature on monetary policy in Japan.

These factors render the correlations reported by Alesina, et al. spurious and misleading. The Bank of Japan as well as the case history of other central banks suggest that what best predicts a low inflation-oriented monetary policy is not institutional form, but rather weather conditions produce a domestic consensus around price stability as a priority. This prioritization of price stability can arise from economic circumstances, such as impending capital flight, declining financial center competitiveness, or diffusion and competition (e.g., Dwyer 2004; Marcussen 2003); cultural factors, such as an aversion to inflation or uncertainty (e.g., Hayo 1998; De Jong 2002; Tognato 2012); or, domestic political factors, such as the degree of political contestation, patterns of union density, or the political power of the financial sector (e.g., Franzese 1999; Posen 1995).

Whatever the reason, the associated question of whether those who have embraced price stability as a central goal choose to institutionalize this priority via central bank independence is really secondary. It's not independence per se but the political economy of the country that permits the central bank to pursue price stability. In short, when domestic conditions foster a consensus regarding the importance of price stability, institutionalizing *de jure* central bank independence may account for the perceived correlation, but there is no causation between institutional design and price stability as evidenced by the Japan case. Conversely, when those conditions do not exist, no manner of institutionalization will produce the outcomes anticipated by the conventional wisdom regarding central bank independence as again evidenced by again by Japan.

That is, *de jure* independence is neither a necessary nor sufficient institutional foundation for price stability. Or, as one article in this literature concludes, "By taking the endogeneity of central bank independence into account…there is no reason to believe the correlation between central bank independence and low inflation tells us anything about causality" (Hayo and Hefeker 2007, p. 1). Thus, broadly speaking, if *de facto* independence and price stability are both a function of the social priority assigned to price stability, there is no need for Rogoff's (1985) "conservative" central banker, the institutionalization of central bank independence, or even an inflation target rule because government and the central bank would have the same policy preferences.

From this perspective, the so-called "Japan Puzzle" is no longer a puzzle. Once the Bank of Japan successfully managed the post-oil crisis inflation spike of the early 1970s, conditions were conducive for the emergence of a broad national agreement that price stability must be given priority: Japan was well integrated into the global economy; labor unions were relatively weak; the financial sector was a major campaign contributor to the dominant party; and, the conservative Liberal Democratic Party had been in power for decades, reducing their incentive to use short-run monetary stimulus for electoral purposes. In other words, by the 1980s Japan's political economy had developed so many conditions encouraging a price stability bias the government and the central bank's orientation towards low inflation were almost over-determined. Japan during the 1980s and early 1990s was not unique in this regard. Franzese argued that at that time "…the developed democracies' political economies have been becoming increasingly anti-inflationary with or without highly independent central banks…the central bank adds nothing further to the anti-inflationary stance of monetary policy however independent it may be (Franzese, 1999, 700-701).

This discussion of how the *de jure* dependent Bank of Japan achieved a price stability record most often associated with a *de jure* independent central bank should not be interpreted to mean the measurement of independence can be improved econometrically by including variables to measure *de facto* independence. These factors are complex and time dependent and under any circumstance would be difficult to model econometrically. Rather, the Japan case highlights a more fundamental problem in that no measure of independence accurately predicts outcomes: price stability was correlated with *de jure* and *de facto* dependence until 1970; inflation was correlated with *de jure* and *de facto* independence until 1972; and, starting in 1973 through the 1980s, price stability was correlated with *de jure* dependence, but *de facto* independence. The difficulty of explaining the

Japan case using the conventional wisdom continues when we consider the Bank of Japan's experience after 1997.

The 1998 to Present Period: The newly *de jure* independent Bank of Japan faced a new environment in the late 1990s as economic, financial and political distress became a feature of Japan after the collapse of the asset bubble in real estate and equity prices in 1990/1991. The Bank had already become a target for criticism before 1997 as many observers were critical of the Bank's unwillingness to shift to easy monetary policy immediately after the burst and when the Bank did shift to easy policy in 1992, it was criticized for not being sufficiently aggressive to prevent deflation. As deflation became a problem after 1994, the criticism intensified, and to complicate matters, the Bank of Japan in 1998 was embroiled in a scandal that led to the resignation of high ranking officials and damaged its reputation at the same time the Bank was provided with a significant increase in *de jure* independence.

The New Bank of Japan Law in 1997 significantly changed the legal relationship between the Bank of Japan and the government, notably including virtually all the components usually identified in the literature as key to ensuring central bank independence. The law not only granted the Bank of Japan formal monetary autonomy, but also created a meaningful Policy Board that explicitly excluded government members except as observers; enabled the Bank to overrule any government request for a policy delay; and, granted the governor a long tenure that cannot be revoked over policy disagreements. These new legal conditions transformed the Bank of Japan from one of the most legally dependent to among the more legally independent central banks (Cargill, Hutchison and Ito 2000, p. 107, Takahashi, 1998, Dwyer 2004).

Nevertheless, the post-1998 Bank of Japan policy outcomes and the contrast with the pre-1998 period outcomes could not be starker. Ironically, and quite contrary to the conventional wisdom, the newly independent Bank of Japan was less successful in terms of achieving price stability than it was in the twenty years before the law was passed. Most notably, the Bank of Japan failed to eliminate the persistent deflation haunting Japan's economy. This failure was due, in part, to very public disagreements between the government and the central bank over fundamental problems plaguing Japan's economy, and, in part, to how the Bank's efforts to withstand government pressure resulted in several inconsistent and inappropriate monetary policy decisions, further undermining the central bank's once-solid reputation.

Under intense pressure, the Bank of Japan in February 1999 reluctantly adopted a zero-interest-rate policy (ZIRP), but wanted to return to "normal" monetary policy as soon as possible as evidenced by its premature increase in the call rate August 2000. In March 2001 the Bank of Japan returned to ZIRP as Japan's economy slid back into recession. The Bank of Japan only reluctantly adopted QEP in 2001 and as a result, QEP was not pursued aggressively until the latter part of 2002, when the Bank again came under intense pressure from the Koizumi government (Cargill and Guerrero, 2006) and outside critics such as Bernanke (2003). The Bank of Japan remained reluctant to continue this policy and, looking for an opportunity to end QEP and in 2006, shifted to "normal" monetary policy by increasing the call rate as the economy began to show signs of recovery and declared an end to deflation. After only a short period however, the Bank of Japan returned to both ZIRP and QEP. ZIRP and QEP continue in response to the Great Recession in the United States starting with the collapse of housing prices in early 2006 and the International Financial Crisis of 2008/2009. [7]

7 The Federal Reserve and European Central Bank have also adopted these policies. On balance, it is difficult to find empirical support ZIRP and QEP have significantly improved economic performance and arguments that had ZIRP and QEP not been pursued, the economic distress would have been more server, are intellectually wanting.

The Bank of Japan did not pursue a consistent and aggressive easy policy before 1998, and after 1998 the Bank used its new independence to resist government pressure to pursue aggressive policy because Bank of Japan officials were concerned monetary easing would be used by the government to postpone serious structure reform and accommodate government deficits. Governor Shirakawa (2008-2013), for example, regularly argued the government was making unrealistic demands on monetary policy in the absence of structural changes and continued fiscal imbalances, and stressed that monetary policy was a necessary but not sufficient condition for ending Japan's deflation and economic malaise (Shirakawa 2012). Most government officials disagreed and this generated significant tension in debates over the appropriate monetary policy/structural reform mix between the Bank of Japan and the government, which only intensified as Japan continued to experience economic and financial distress into the new century.

The Bank's strong defense of its independence and its adamant refusal to ease monetary conditions in the ways demanded by politicians and government officials only further encouraged politicians' antagonism towards the Bank. As a result, the period of the Bank of Japan's *de jure* independence coincided with the unprecedented politicization of monetary policy in Japan (Dwyer, 2012). The Bank was criticized by politicians in and out of government almost from the beginning on independence; however politicians' challenges to the Bank's independence at first were not strongly supported by dominant party leaders and thus had minimal influence on Bank of Japan policy. Over time the Bank of Japan had to contend with more intense and better-organized political challenges and ultimately, with the appointment of the Kuroda management team the Bank abandoned all efforts to resist government policy preferences.

This decade-long politicization of monetary policy was not inevitable; some central banks retain both *de jure* and *de facto* independence for long periods of time because the social consensus regarding monetary policy is sustained by broader political, cultural and/or economic conditions. In Japan, however, two developments eroded the social consensus regarding the price stability and increased politicians' incentives to redefine appropriate monetary policy.

First, Japan's deteriorating fiscal position and revised regulatory apparatus increased the government's reliance on monetary policy to solve a range of macroeconomic problems. This change in circumstances is not unique to Japan and accounts for the growing politicization of monetary policies in the U.S. and elsewhere. Second, intense political instability combined with electoral and administrative reforms introduced in 1994 not only encouraged this attention to monetary policy as a means to provide broader-ranging electoral benefits, but also made politicians more accountable for policy making and policy outcomes, thus heightening the electoral costs to each of the Bank's unsuccessful monetary policies. As political uncertainty intensified over this period, politicians felt increasingly desperate for monetary policy to provide the conditions that would sustain them in office, and their efforts to reassert control over the Bank of Japan increased accordingly (Dwyer, 2012).

Response to the Politicalization of Monetary Policy starting in 1998: Different Bank governors responded to these pressures differently. Governors Hayami (1998 - 2003) and Shirakawa, who presided over the worst periods of deflation, reacted as predicted by Wim Duisenberg's "whipped cream" metaphor regarding central bankers: "The more politicians stir them, the stiffer they become" (cited in Eijffinger & Hoerberichts 2008, p. 743). That is, the more politicians complained, the more these governors seemed to go out of their way to both avoid any policy change that might look like capitulation to the government's wishes and explain to the broader public why they disagreed with the government's monetary policy preferences. Shirakawa introduced a number of unorthodox policies during his tenure, and thus could make the case the Bank was earnestly trying to end deflation, but resisted taking the specific steps regularly demanded by politicians, such as adopting an explicit inflation target, directly underwriting Japan Government

Bonds and expanding the Bank's objectives beyond price stability to include employment and growth. In the end, however, these efforts by the bank to resist growing political criticism of the Bank were unsuccessful.

At the time of the Liberal Democratic Party's broad victory in the December 2012 election, the incoming administration and opposition parties agreed that Bank of Japan policy had failed and virtually all wanted the central bank to do what the political consensus at the time deemed necessary – significantly expand the money supply. The Bank of Japan could see clearly that the threats to its continued independence were growing rapidly; in order to protect the *de jure* independence achieved in 1997, the Bank of Japan finally agreed to a 2% inflation target and more aggressive quantitative easing. Nevertheless, domestic support for an independent Bank of Japan continued to deteriorate. *De facto* independence, which had been challenged for years, essentially disappeared with Shirakawa's retirement in March of 2013 and the appointment by the Abe administration of the Kuroda management team. *De jure* independence persists, but for all practical purposes, is not operative.

Bank of Japan Independence Since 1997 - *De Jure* Independence Breeched: The history recounted above demonstrates that the institutional independence granted the Bank of Japan in 1997 was ultimately a thin wall easily breeched by the government. *De jure* independence is in general, and in the case of Japan was in practice far more susceptible to changing domestic conditions than most measures of independence suggest. Although governments always and everywhere have the option of reducing or eliminating central bank independence by changing the defining laws[8], in the Japan case, a change in statute was not required. What does it say about the robustness of independence or its utility in predicting monetary policy outcomes if a simple change in management results in such radically different policies? Yes, the new management at the Bank of Japan looks far more politically responsive. But, political responsiveness is exactly what the conventional wisdom regarding central bank independence suggests one should avoid.

Central bank independence, however measured, was and always will be a function of how far bank policy can deviate from the government's preferred policy before the government decides the benefits of revoking independence are worth the costs of doing so (Keefer and Stasavage, 2003). Legislating *de jure* independence does not change this basic equation except to the extent that the legislative processes required to revoke independence and any potential market reactions make unwinding institutional independence somewhat more costly.[9] Most important, a government's ability to tolerate agency slack, or alternatively bear the costs associated with diminishing central bank independence, are functions of domestic political economy conditions.[10]

Most obviously, economic conditions influence how much slack the government will tolerate

8 Federal Reserve Chairman Alan Greenspan acknowledged the same point with regard to the United States: "I regret to say that Federal Reserve independence is not set in stone. FOMC [Federal Open Market Committee] discretion is granted by statue and can be withdrawn by statute (Greenspan, 2007, 478).

9 From this perspective, it is noteworthy that the new Liberal Democratic Party government and coalition partners did not choose to revoke the Bank of Japan's independence, but essentially accomplished the same end by appointing a management team who agrees with its wishes. While easier than legislation, this approach also avoids any potential reputational costs that might be associated with being the only government to revoke central bank independence.

10 Although economists have offered ample economic arguments for why government should pursue price stability, all of the arguments summarized here recognize governments often adopt policies for reasons other than economic efficiency, such as distributing resources to preferred constituents or to maintain and enhance political power by remaining in office.

from the central bank. A growing economy with steadily rising incomes and tax revenues creates greater leeway and patience with perceived monetary policy digressions than does a deteriorating economy with declining prices, stagnant incomes and increasing inequality. This alone helps explain why post-1997 politicization of monetary policy in Japan fluctuated more or less with economic conditions, declining notably when the economy appeared to be improving (Dwyer, 2012).

The Bank of Japan's recent experience also illustrates a broader challenge to independent policymaking by central banks in Europe and the United States. The challenge has little to do with fundamental relationships no longer being applicable, such as the long-run relationship between money and price stability, although there is a renewed interest in the ability of the central bank to exploit the short-run Phillips curve. Rather, it comes from governments assigning a growing number and broader range of responsibilities to central banks; encouraging more activist central bank policy; and, the longer term difficulties central banks may face by coordinating policy with governments that in many cases lack the political will to resolve fiscal imbalances and serious structural constraints in a manner that encourages economic growth. In addition, as central banks are increasingly expected to reach a larger number of goals, many of which they cannot achieve without coordination with other agencies, political acceptance of central banks' monetary policy independence may well decline. These new central banking challenges are fundamentally related to what we now understand are the more specific conditions under which central bank independence has meaning and that define what central banks will be expected to pursue and can realistically be expected to accomplish (Plosser, 2011).

4. Implications for Central Bank Independence in General

The postwar history of the Bank of Japan prior to 1998 has repeatedly challenged the conventional wisdom that *de jure* independence is an important foundation for the central bank to achieve price stability. Nevertheless, the case of Japan has been regarded as an aberration or largely ignored in the central bank independence literature because it was only one observation in the standard regression models that appeared to generate statistically robust support for the conventional wisdom. The postwar history of the Bank of Japan since 1998 to the present represents another challenge to the conventional wisdom and more important, provides a most transparent illustration that *de jure* independence neither isolates central bank policy from political influence nor ensures the central bank will achieve price stability.

Given all the ways the Japan case challenges the conventional central bank independence argument, especially when combined with the econometric problems with the measurement literature (Campillo and Miron, 1997; Cargill, and 2013; Fujiki, 1996; Oatley, 1999; Hayo and Hefeker, 2007 and Posen, 1998), we conclude with the following several points:

First, attempts to measure independence based on *de jure* relationships with the government are flawed and the political economy in which the central bank operates makes it unlikely *de jure* considerations can be modeled by simply adding variables to measure *de facto* independence. *De facto* independence is inherently complex and most important, is not time invariant.

Second, central bank independence whether *de jure* or *de facto* is fragile and conditional. The Abe government embraced a revised understanding of Bank of Japan independence by leaving in place its *de jure* independence, but reducing its *de facto* independence. This was achieved by appointing a management team who agreed with the monetary policy preferences of the government. This, or course, is an option available in any country where central bank management requires government approval. Given that a radical change in Bank of Japan policy was achieved

virtually overnight, without new legislation or the imposition of a government mandated inflation target, central bank independence established through legislation is not enduring over time.

Third, the extent to which central bank policy is allowed to deviate from the government's preferred path or a social consensus is shaped by many factors and varies across time with political and economic conditions. Rules, such as inflation targeting, provide a reasonable framework for central bank price stability policy, but like *de jure* independence, rules will only be effective if there is a high social priority placed on price stability and/or key political actors support a consensus for price stability. These domestic political economy conditions are what determine monetary policy for all practical purposes; *de jure* independence is neither necessary nor sufficient to generate preferred price stability outcomes.

Fourth, central banks are increasingly being called upon to expand their role beyond price stability and in so doing may not only lose their *de facto* independence but also reduce their credibility in maintaining long term price stability. Once the central bank becomes a de facto agent of the government's broader set of objectives, like Abe's "three arrows", which the central bank is not able to achieve on its own, the central bank may well become less capable of achieving even price stability. Although still too early to tell, even if Abenomics proves successful, it may not be easy for the Bank of Japan to restore its credibility as an autonomous agency because the radical effects of the past management change will linger for a long time. Moreover, when "normal" monetary policy conditions return it may be more difficult for the market to accept a government claim that it can "tie its own hands" and credibly commit to resist using monetary policy for shorter term or more purely political goals given the evidence since 2013 of how weak those ties really are in practice.

Economic theory and history suggest central banks are rarely capable of achieving multiple goals and the more *de facto* dependent the central bank becomes, the more it has to rely on the government's willingness and ability to make the correct policy decisions over which it has no control. One of Abe's own economic advisors assessed the Bank of Japan's monetary policy as earning a 100%, but the government's fiscal and restructuring "arrows" as falling quite short at just 60% (Hamada quoted in Schlesinger 2013). Other assessments of Abenomics have been far less generous, suggesting "the third arrow has not even been fired yet" (Wassener 2013). This situation is emerging in the United States and Europe as well, where central banks are being asked to depart from their traditional focus on price stability to achieve multiple goals; for example, both the Federal Reserve and the Bank of England have recently privileged lower unemployment over a narrow focus on price stability. It is certainly conceivable that the Bank of Japan will follow this trend despite the prominence of the price stability goal in the 1997 Bank of Japan Law.

Fifth, the continued focus on central bank independence while central banks are being increasingly asked to pursue additional or alternative objectives, confuses the market and complicates the ability of the market to form inflationary expectations. Central banks are now expected to produce price stability, full employment, industrial policy and financial stability, despite significant lack of clarity regarding exactly what financial stability means or how it is to be achieved (Goodhart and Tsomocos 2010). In this sense, the Bank of Japan is a leading indicator of the new challenges facing central banking around the world.

5. Concluding Comment

In closing, this paper argues that the history of the Bank of Japan includes several episodes that contradict the conventional wisdom. This history suggests the enormous emphasis placed on institutionalizing central bank independence as a way to achieve beneficial monetary policy outcomes is rather misdirected and should be replaced with an effort to better understand the

political economy conditions that first lead governments to prioritize price stability over other objectives, and then second, shape how the central bank can be held accountable for price stability. In other words, rather than measuring independence, we should redirect effort towards more carefully specifying the conditions under which a central bank is held accountable for price stability. Japan's case provides important insight into the central bank independence discussion. Central bank independence is neither necessary nor sufficient to generate price stability. Combined with the weak statistical correlations, the importance given central bank independence has been greatly exaggerated.

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