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Class 7

The Bank of Japan:
Student Presentation

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The Bank of Japan

The evolution of Central Banking in Japan, up to the 1950s

- Meiji period (1868-1912): Japan achieved a major transition from an agricultural to industrialized economy
- Establishment of a National banking system in 1872
- National Banking system revised in 1876
- The Bank of Japan established in 1882
- The bank of Japan Law revised in 1942

The Bank of Japan Law, as revised in 1942

- The central Bank was now placed entirely under the control of the Ministry of Finance
- Article 42: "The Bank of Japan shall be **under the supervision** of the competent Minister"
- Article 43: "The competent Minister may, **whenever deemed necessary** for the attainment of the object of the Bank of Japan, **order** the Bank to undertake any necessary business, or order alterations in the By-Laws as well as other necessary action"

The Bank of Japan Law, as revised in 1942

- No reference to price stability
- Very broad "target"
- Staff appointed by Ministry of Finance
- The Central Bank was just an economic instrument among others for the government

Main modifications to the 1942 Law

- 1949 the policy board was created (members were from city banks or retired officials)

- The Parliament has to authorize major issuing of debt

Phases of Japan's Monetary-Policy Experience

- 1945-1950:
- A period of great trauma, economic devastation, and high inflation after a war that virtually destroyed Japan's industrial capacity
- Provided little flexibility for independent monetary policy
- "The Dodge Plan"

Phases of Japan’s Monetary-Policy Experience

- 1950-1971:
- “High growth period”: Rapid real GNP growth and moderate inflation
- Bretton Woods period of fixed exchange rates
- The Bank of Japan’s policy during this period should be judged as a success

Major changes in 1975

- Oil price shock and end of Bretton Woods
- No fixed exchange rate
- Ministry of Finance decides monetary expansion, opposition of the Bank of Japan
- Result is double digit inflation
- The position of the Ministry of Finance is weakened resulting in de facto independence of the Bank of Japan
- Price stability target is adopted

Phases of Japan's Monetary-Policy Experience

- 1975-1985:
- Bank of Japan adopted a more independent approach that allowed it to focus on domestic price stability; low inflation
- Contradicts classical theory of a need for Central Bank independence
- With GNP growth fluctuating between 3 and 5 percent per year and low rates of inflation, Japan became the second largest economy in the world

Phases of Japan's Monetary-Policy Experience

- 1985-1996:

- Asset price inflation in the first five years, asset-price deflation in the next five years.

- The bubble began to burst in May 1989, when the Bank of Japan raised the discount rate

The New Bank of Japan

- In 1996 Hashimoto finally tackles the question of Central Bank independence
- Support by the Ministry of Finance which was weakened due to scandals and mismanagement
- External and internal events led to this development

External Events

- Academic research showed that money growth led to inflation and that independence would reduce inflation risk

- Worldwide financial liberalization and financial distress in the 1980s and 1990s led to rethinking of Central Bank position

Internal events

- The position of the Ministry of Finance was weakened due to the inability to solve nonperforming loan problem
- 1996 Big Bang financial reforms
- 1997 reforms reduced the Ministry of Finance's position regarding supervision and regulation
- Legal independence was granted to the Bank of Japan

Internal events

- Some argued the asset inflation an the subsequent collapse of asset prices showed the need for an independent Bank of Japan
- Ueda showed that the Bank of Japan ran a money growth to prevent yen appreciation while the government ran a deficit hence the asset bubble
- Nevertheless the Bank of Japan had gained reputation for price stability

The report of the Hashimoto committee

- The 1942 law is outdates
- The primary goal should be price stability and fluent payment system
- Open independence
- Transparency and independence
- Strengthening the policy board

The report of the Hashimoto committee

- Important monetary policy decisions have to be made by the bank
- Relationship between the Bank of Japan and the government (independence regarding monetary policy, cooperation regarding payment system, government responsibility when it comes to foreign exchange intervention and management of government funds)
- Bank of Japan as Banker of banks

The 1998 Law

- Two main targets price stability and fluent payment system (shared with the government)
- The Bank of Japan may intervene on the foreign exchange market (no clear division between the 2 agencies regarding forex market)
- The Bank of Japan may make uncollaterized loans to the government but they are limited (an extension to the limit must be granted by the diet)

The 1990s

- The situation in Japan is precarious
- Very challenging environment for the Bank of Japan, new law
- What can the Central Bank do to stop deflation and increase growth?
- Situation where monetary policy seems totally ineffective to give any stimulus to the economy
- Some argued that an adoption of an inflation target would have helped (Krugman 1998)

Liquidity trap argument

- Krugman argued that the Bank of Japan was in a liquidity trap position, hence useful to introduce an inflation target => increasing expectations of inflation
- Only correct If one simplifies the reality a lot

Bank of Japan and Institutional Features of Inflation Targeting

- The 1998 law narrows the objectives down to two: the pursuit of price stability, maintenance of an orderly financial system

- The financial system stability is a shared responsibility with the government and the regulatory agencies

Bank of Japan and Institutional Features of Inflation Targeting

- The decision-power of the Policy board has been reaffirmed. Even though it had a lot of decision power under the old law it barely assumed it.

- 9 members: 3 representatives of the Bank of Japan

  6 experts chosen by the cabinet with the approval of the diet (don't have to be related to Banks or Ministry)

Inflation Targeting to stop deflation

- Research shows that having a nominal anchor regarding inflation can help bring a country out of deflation.
- The Bank of Japan tried to ease the situation by trying to increase liquidity.
- This mainly happened by using repo agreements with commercial banks hence increasing lending possibilities.

Inflation Targeting to stop deflation

- There could have been a more aggressive stance to counter this situation.
- An other instrument could have been the purchase of long term government bonds
- If there would have been an inflation target an independent Bank of Japan would have reacted more aggressively