

# Central Banking in Japan

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## 1. Introduction

It was once said that the Bank of Japan ("BOJ"), the central bank in Japan, was one of the least independent central banks in the developed world, and trailed even many developing countries. Professor Geoffrey P. Miller, who made this statement, presented a puzzle in the following way:

"On top of this puzzle is a related anomaly. Political theory predicts, and the empirical research confirms, that at least in the developed world, the legal independence of a country's central bank tends to correlate with lower inflation. The intuition is that an independent central bank will be able to resist the demands of political actors that it print money to pay the government's debts or that it engage in stimulative monetary policy in order to enhance the governing party's re-election prospects. On this theory, Japan ought to have high inflation. But it doesn't. Japan's inflation rate is one of the lowest in the developed world, and has been at the low end of world inflation rates for many years."<sup>1</sup>

Professor Miller then offered two interesting theories regarding the role of the BOJ:

"The first draws on the remarkable political stability that characterized Japanese politics between the end of the Second World War and the recent past, a stability based largely on a commitment by the ruling party to pursuing policies designed to foster rapid economic growth. The second draws on a model of bureaucratic decision-making at the BOJ that appears

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<sup>1</sup> Geoffrey P. Miller, *Decision Making at the Bank of Japan*, 28 *Law and Policy in International Business* 1, at 3 (1996). See also Geoffrey P. Miller, *The Role of a Central Bank in a Bubble Economy*, 18 *Cardozo Law Review* 1053 (1996) (examining the role of the Bank of Japan against the economic situations in Japan in the 1990s).

to be richer and more complete than the model implied by the simple "independent-dependent" measure of central bank independence. I argue that the BOJ's decisions on monetary policy questions are arrived at through a process of "preclearance" in which decisions are thoroughly vetted and discussed by the relevant actors who may include officials of the Ministry of Finance as well as the BOJ-before they are publicly announced. Preclearance allows the Bank to maintain a substantial degree of control over the decision-making process while at the same time subjecting the Bank to influences from without that render it accountable to the political system."<sup>2</sup>

In this chapter, we do not pursue an academic inquiry along the lines examined by Professor Miller. Suffice it to say that as a matter of fact, the Bank of Japan Act, which provides the legal foundation for the BOJ, was significantly amended in 1997. In the following, we first will describe the major points of the amendments in 1997 and the legal regime on which the BOJ stands today. Our focus will be on the basic governance structure of the central bank and the related institutional setting for the BOJ's monetary policy and prudential policy. We will then briefly take up two areas – one is how the BOJ's unconventional monetary policy worked from 1999 to present and the other is how the BOJ's power of on-site examinations, which is unique in Japan as compared to other nations, has been applied. In Section 2, we will describe the legal regime for the BOJ. In Section 3, we will examine the BOJ's unconventional monetary policy from 1999 to present. In Section 4, we will discuss the BOJ's on-site examinations. Section 5 is our brief conclusion.

## **2. Institutional setting of the BOJ: the Bank of Japan Act<sup>3</sup>**

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<sup>2</sup> Miller, *supra* note 1 (Decision Making), at 3-4.

<sup>3</sup> This section of the chapter draws on Hideki Kanda, *Reform of the Bank of Japan Act*, 1119 *Jurisuto* 16 (1997) (in Japanese). A comprehensive explanation of the BOJ and its functions is found in English at the Institute for Monetary and Economic Studies, Bank of Japan ed., *Functions and Operations of the Bank of Japan* (2nd ed., 2012) (available at: <http://www.boj.or.jp/en/about/outline/foboj.htm/>).

## 2.1 Independence

The BOJ was founded in 1882 as the central bank of Japan. The BOJ's purposes and its organization are stipulated in the Bank of Japan Act. The Bank of Japan Act was enacted in 1942 to replace the Act of 1882 (Act No. 67 of 1942; hereinafter referred as "the BOJ Act" or "the Act"). The Act was completely amended and modernized in 1997 (effective from 1998) based on two principles: respecting the autonomy of the BOJ and ensuring transparency of its monetary policy and business operations.<sup>4</sup> Under the regime after the amendments in 1997 ("new regime"), the purpose of the BOJ has been to issue banknotes and to carry out currency and monetary control (Article 1(1)). In addition, the BOJ Act provides that the BOJ's purpose is to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of stability of the financial system (Article 1(2)). What does "currency and monetary control" mean? Indeed, the BOJ Act provides that currency and monetary control by the BOJ shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy (Article 2). This means that price stability in Japan is most important where the BOJ implements its currency and monetary policy.

The BOJ Act also requires autonomy and transparency. It provides that the BOJ's autonomy regarding currency and monetary control shall be respected (Article 3(1)) and the BOJ shall endeavor to clarify to citizens the content of its decisions, as well as its decision-making process, regarding currency and monetary control (Article 3(2)). In this connection, the Act requires coordination with the government by providing that the BOJ shall, taking into account the fact that currency and monetary control is a component of overall economic policy, 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

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<sup>4</sup> English translations of major statutes in Japan, including the Bank of Japan Act, are available at the "Japanese Law Translation" website (<http://www.japaneselawtranslation.go.jp>). In the following text, article numbers to be cited refer to those of the current Bank of Japan Act, unless otherwise noted.

shall be mutually compatible (Article 4). It should also be noted that the Public Finance Act (Act No. 34 of 1947), in principle, prohibits the BOJ from directly underwriting Japanese government securities (Article 5 of the Public Finance Act).

The notion of autonomy under the BOJ Act mentioned above corresponds to the notion of independence of the central bank in the literature.<sup>5</sup> To ensure autonomy, the BOJ Act provides a general rule and specific measures. As a general rule, the Act provides that in implementing the Act, due consideration shall be given to the autonomy of the BOJ's business operations (Article 5(2)). Specific measures include three aspects. First, under the regime before the amendments in 1997 ("old regime"), the government had power to issue orders to the BOJ regarding various operations. Under the new regime, such power does not exist. Also, the Governor and other members of the BOJ's Policy Board cannot be removed from their office unless there are reasons specified under the Act, and in no case can a difference in opinions between the government and the BOJ be the reason for removal (Article 25(1)). Second, the amendments in 1997 made for complete renewal of the BOJ's Policy Board, as described later. Finally, the amendments introduced measures limiting the government's control over the BOJ's budget (Article 51), thereby ensuring the autonomy of the BOJ.

## 2.2 Policy Board

Under the new regime, the Policy Board ("Board") is the only decision-

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<sup>5</sup> Literature on central bank independence abounds. See, e.g., Rosa Maria Lastra, *The Independence of the European System of Central Banks*, 33 *Harvard International Law Journal* 475 (1992); Rosa M. Lastra, *International Financial and Monetary Law*, at 64-82 (2nd ed., OUP, 2015); Christopher Crowe and Ellen E. Meade, *Central bank independence and transparency: Evolution and effectiveness*, 24 *European Journal of Political Economy*, 763 (2008); Stanley Fischer, *Central Bank Independence* (remarks at the 2015 Herbert Stein Memorial Lecture National Economists Club, Washington, D.C., 4 November 2015) (available at: <http://www.federalreserve.gov/newsevents/speech/fischer20151104a.pdf>).

making body at the BOJ, and its power is specified under the Act (Articles 14 and 15). Under the old regime, the Board consisted of seven members; the Governor, four members, and two representatives of the government. Under the new regime, the Board consists of nine members; the Governor, two Deputy Governors, and six members (Article 16). The term of office is five years (Article 24). Under the new scheme, representatives of the government are not included in the Board. Rather, the BOJ Act provides a new measure for coordination between the government and the BOJ. Specifically, the Act provides, in essence, that the Minister of Finance may, when necessary, attend and express opinions at Board meetings for monetary control matters, or may designate an official of the Ministry of Finance to attend and express opinions at such meetings (Article 19(1)). The Minister of Finance (or its delegate) may, when attending the Board meetings for monetary control matters, submit proposals concerning monetary control matters, or request that the Board postpone votes on proposals on monetary control matters submitted at the meeting until the next Board meeting for monetary control matters (Article 19(2)). When a request has been made to postpone a vote as prescribed above, the Board shall decide whether or not to accommodate the request, in accordance with the Board's practice for voting (Article 19(3)).<sup>6</sup>

Note that the Board makes decisions not only regarding monetary control but other important matters as well (Article 15(1) for monetary control and Article 15 (2) for other important matters). Disclosure of the outline of each Board meeting and its minutes is required only for meetings regarding monetary control (Article 20).

The BOJ's Board meetings for monetary control are called Monetary Policy Meetings, and those meetings, in principle, took place 14 times a year until the end of 2015. Beginning 2016, they take place, in principle, eight times a year,<sup>7</sup> which is similar to practice in the US and Europe.

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<sup>6</sup> This request was made in 2000 as described later in Section 3.

<sup>7</sup> Article 9 (2) of the Bank of Japan Act Implementation Ordinance (Ordinance No. 385 of 1998, as amended in 2015). See Bank of Japan, New Framework for Monetary Policy Meetings (19 June 2015). (available at: [http://www.boj.or.jp/en/announcements/release\\_2015/re1150619a.pdf](http://www.boj.or.jp/en/announcements/release_2015/re1150619a.pdf))

## 2.3 Governance

Aside from the Policy Board, the BOJ has other officers; executive directors, counsellors and auditors. Auditors are appointed by the Cabinet (Article 23(3)), and executive directors and counsellors are appointed by the Minister of Finance based on the Policy Board's recommendation (Article 23 (4)).

Under the old regime, the government had supervisory power over the BOJ and sent a supervisor to the BOJ. Under the new regime, the system of supervisor was abolished, and the government's supervisory power became limited to matters concerning compliance of the BOJ's business operations with laws and regulations. Under the old regime, the government was given power of on-site examination over the BOJ, but this was abolished. Under the new regime, the government can only ask auditors to take necessary actions where violations of laws or regulations are likely to exist (Article 57).

Thus the BOJ's autonomy, or independence, from the government is ensured as much as possible under the current BOJ Act. With this framework of governance, how the BOJ operates is an interesting inquiry. This is hardly the place to examine the details of the BOJ's operations. Recent literature emphasizes the importance of governance of central banks, and the key elements of governance include independence, accountability and transparency.<sup>8</sup> We think that monetary control and other business should be differently analyzed from the perspective of corporate

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<sup>8</sup> See Bank for International Settlements, *Issues in the Governance of Central Banks* (a report from the Central Bank Governance Group) (2009) (available at: <http://www.bis.org/publ/othp04.pdf>); Bank for International Settlements, *Central bank governance and financial stability* (a report by a Study Group) (2011) (available at: <http://www.bis.org/publ/othp14.pdf>). See also Ellen E. Meade, *The Governance of Central Banks*, in David Levi-Faur ed., *The Oxford Handbook of Governance*, at 401 (OUP, 2012); Gerard Hertig, *Central Bank Governance*, 2012 *Swiss Review of Business and Financial Market Law* 486 (2012).

governance. The purpose of monetary policy and that of prudential policy are not identical, and they must be evaluated separately from different perspectives as described later in Sections 3 and 4.

## **2.4 Business other than monetary control**

The BOJ undertakes business other than monetary control. Here we describe its major business.

### **2.4.1 Stability of financial system**

In Japan, the power to regulate financial institutions is given to the government, not the BOJ. The BOJ, however, has been given the following three powers. First, the BOJ has power to make "special lending," which is generally known as the central bank's lending as the lender of last resort. Under the BOJ Act, this lending can be made in two contexts. One is temporary lending to individual financial institutions in response to liquidity shortage, which can be done at the BOJ's judgement only, that is, without consultation with the government in advance (Article 37). The other is special lending to individual financial institutions upon a request by the government (Article 38). This lending is also intended to deal with liquidity problems, but not with the solvency of individual financial institutions.

Second, upon authorization from the government, the BOJ may engage in the business of contributing to smooth settlement of funds among financial institutions under certain conditions (Article 39). In fact, the BOJ operates a payment and settlement system and a settlement system of government securities.

Finally, the BOJ undertakes on-site examinations of financial institutions. The BOJ Act did not have any explicit provision regarding this before the amendments in 1997, and the amendments introduced a new provision, Article 44. Article 44 is a product of a compromise that was reached after lengthy discussions in the legislative process immediately before the amendments to the BOJ Act in 1997, and reads as follows.

"(1) The BOJ may, for the purpose of appropriately conducting or preparing to conduct the business prescribed in Articles 37 through 39, conclude a contract with financial institutions which would be the counterparties in such business ("counterparty financial institutions") concerning on-site examinations (examinations which the Bank carries out regarding the business operations and the state of the property of the counterparty financial institutions by visiting the premises thereof) (such contract shall meet the requirements specified by Cabinet Order including those whereby the Bank shall notify and obtain prior consent from the counterparty financial institutions when carrying out on-site examinations). (2) The BOJ shall consider the administrative burden incurred by counterparty financial institutions when carrying out on-site examinations."<sup>9</sup>

The point is that the BOJ's on-site examinations are legally carried out based on a contract between the BOJ and each financial institution. In other words, the BOJ's legal power of on-site examination arises from a contract, not the BOJ Act. The Act purports to provide certain conditions. In Section 4, we will further discuss the BOJ's on-site examinations.

#### **2.4.2 International finance**

The BOJ's business regarding international finance includes three categories (Articles 41 and 42). The first is banking operations such as deposit taking from foreign central banks, which can be done based on the BOJ's judgement only. The second is international rescue measures, which can be made upon a request by the government. The third is foreign exchange control, which is decided solely by the government and implemented by the BOJ.

#### **2.4.3 Issuing banknotes**

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<sup>9</sup> Article 44 (3) reads as follows: "(3) When a request has been made from the Commissioner of the FSA, the BOJ may submit documents describing the results of on-site examinations and other related materials to the Commissioner or have officials of the FSA inspect them."



The BOJ issues banknotes, and they are legal tender (Article 46).

### **3. The BOJ's unconventional monetary policy from 1999 to present<sup>10</sup>**

In this section, we summarize how the BOJ's unconventional monetary policy has been adopted and implemented under the new BOJ Act. We also briefly review theoretical and empirical aspects of this monetary policy.

#### **3.1 An overview of the BOJ's unconventional monetary policy**

Under the new BOJ Act, the BOJ has been implementing an unconventional monetary policy from 1999 to present.<sup>11</sup> Over this period, the nominal interest rate in Japan has been consistently nearly zero, and the BOJ adopted several tools of an unconventional monetary policy – which include increasing the amount of current deposits of financial institutions with the BOJ or the "monetary base" – in order to maintain price stability (see Chart 1 below).<sup>12</sup>

[Insert Chart 1 around here]

Specifically, the BOJ's unconventional monetary policy includes the following three types: (i) "zero interest rate policy" (ZIRP) from 1999 to 2000, (ii) "Quantitative Easing Policy" (QEP) from 2001 to 2006, and (iii) "Quantitative and Qualitative Monetary Easing" (QQE) from 2013 to present. Under the last QQE policy, the BOJ introduced "QQE with a

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<sup>10</sup> This section is partly based on Toshiaki Yamanaka, *Bank of Japan's Unconventional Monetary Policies: A New Approach for Verifying Their Effectiveness* (unpublished, M.P.A. thesis at Columbia University, 2012).

<sup>11</sup> As of 15 February 2016.

<sup>12</sup> In other words, the primary means of monetary policy has changed from a traditional adjustment of the nominal interest rate to a use of the central bank's balance sheet. For a theoretical perspective, see Vasco Cúrdia and Michael Woodford, *The central-bank balance sheet as an instrument of monetary policy*, 58 *Journal of Monetary Economics* 54 (2011).

Negative Interest Rate" on 29 January 2016 (effective 16 February 2016).<sup>13</sup>

### 3.2.1 Zero interest rate policy (ZIRP): 1999-2000

Japan's economy experienced a decade of economic stagnation from the burst of the bubble in the early 1990s.<sup>14</sup> In February 1999, the BOJ decided to "provide more ample funds and encourage the uncollateralized overnight call rate to move as low as possible."<sup>15</sup> This is called "zero interest rate policy" (ZIRP). Further, in an interview in April 1999 after the Monetary Policy Meeting of the BOJ Policy Board, the Governor of the BOJ announced that the bank would continue the ZIRP until it would become confident that "Japan's economy has reached the stage where deflationary concern has been dispelled."<sup>16 17</sup>

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<sup>13</sup> Bank of Japan, Introduction of "Quantitative and Qualitative Monetary Easing with a Negative Interest Rate" (29 January 2016). (available at: [http://www.boj.or.jp/en/announcements/release\\_2016/k160129a.pdf](http://www.boj.or.jp/en/announcements/release_2016/k160129a.pdf))

<sup>14</sup> For the background, see Fumio Hayashi and Edward C. Prescott, *The 1990s in Japan: A Lost Decade*, 5 Review of Economic Dynamics 206 (2002) (provided a supply-shortage hypothesis).

<sup>15</sup> Bank of Japan, Announcement of the Monetary Policy Meeting Decisions (12 February 1999). (available at: [http://www.boj.or.jp/en/announcements/release\\_1999/k990212c.htm/](http://www.boj.or.jp/en/announcements/release_1999/k990212c.htm/)) The BOJ's assessment on the economy was as follows: "[C]orporate and household sentiments remain cautious and private sector activities stagnant. Prices are on a downward trend. Clear prospects for rebound of the economy have yet to emerge. With respect to financial developments, tight conditions once observed in inter-bank transactions and corporate funding have subsided. However, long-term interest rates have risen considerably, and the yen has been appreciating against the dollar. Stock prices, on the whole, have been weak. Such market developments could have an adverse impact on the future prospect[s] of our economy." Id.

<sup>16</sup> Bank of Japan, Sousai Teirei Kisha Kaiken Youshi (Outline of the regular interview by the Governor) (made on 13 April 1999 and published on 14 April 1999) (available at: [http://www.boj.or.jp/announcements/press/kaiken\\_1999/kk9904a.htm/](http://www.boj.or.jp/announcements/press/kaiken_1999/kk9904a.htm/)) (in Japanese).

<sup>17</sup> Regarding the announcement of the ZIRP, Professor Bernanke

In August 2000, despite the request from the government to postpone the vote,<sup>18</sup> the BOJ lifted the ZIRP and decided to "encourage the uncollateralized overnight call rate to move on average around 0.25%" with the view that "Japan's economy has reached the stage where deflationary concern has been dispelled."<sup>19</sup> <sup>20</sup>

### 3.2.2 Quantitative Easing Policy (QEP): 2001-2006

In March 2001, the BOJ decided to change its primary target for money market operations from the uncollateralized overnight call rate to the outstanding balance of current accounts at the BOJ and set consumer price index (CPI) guidelines for the duration of this policy – "[t]he new procedures for money market operations continue to be in place until the consumer price index (excluding perishables, on a nationwide statistics) registers stably a zero percent or an increase year on year."<sup>21</sup> This is called

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commented that "[a] problem with the current BOJ policy, however, is its vagueness." Ben S. 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 U.S. Experience*, Special Report 13, Institute for International Economics, at 149, 159 (2000).

<sup>18</sup> See supra note 6. The Policy Board rejected this request by a majority vote. Bank of Japan, *On the Request from the Government to Postpone the Vote* (11 August 2000). (available at:

[http://www.boj.or.jp/en/announcements/release\\_2000/k000811b.htm/](http://www.boj.or.jp/en/announcements/release_2000/k000811b.htm/))

<sup>19</sup> Bank of Japan, *Change of the Guideline for Money Market Operations* (11 August 2000). (available at:

[http://www.boj.or.jp/en/announcements/release\\_2000/k000811.htm/](http://www.boj.or.jp/en/announcements/release_2000/k000811.htm/))

<sup>20</sup> For an explanation of the ZIRP and the transmission mechanism under it by one of the Board members at that time, see Kazuo Ueda, *Japan's Experience with Zero Interest Rates*, 32 (4) *Journal of Money, Credit and Banking* 1107 (2000); Kazuo Ueda, *The transmission mechanism of monetary policy near zero interest rates: the Japanese experience, 1998-2000*, in Lavan Mahadeva and Peter Sinclair eds., *Monetary Transmission in Diverse Economies*, at 127 (Cambridge Univ. Press, 2002).

<sup>21</sup> Bank of Japan, *New Procedures for Money Market Operations and Monetary Easing* (19 March 2001). (available at: [http://www.boj.or.jp/en/announcements/release\\_2001/k010319a.htm/](http://www.boj.or.jp/en/announcements/release_2001/k010319a.htm/))

"Quantitative Easing Policy" (QEP). This quantitative easing (QE) is often referred as large-scale asset purchases (LSAPs). It is a tool first deployed in 2001 by the BOJ, and then used more widely since the financial crisis by the US Federal Reserve, European Central Bank and the Bank of England.<sup>22</sup>

The BOJ retained this policy until March 2006 when it decided to change again the target of money market operations back to the uncollateralized overnight call rate with a view that the core CPI growth is expected to be positive and thus "the conditions laid out in the commitment are fulfilled."<sup>23</sup>

### 3.2.3 Quantitative and Qualitative Easing Policy (QQE): 2013 - present

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The BOJ's assessment on the economy is as follows;

"Japan's economic recovery has recently come to a pause after it slowed in late 2000 under the influence of a sharp downturn of the global economy. Prices have been showing weak developments and there is concern about increase in downward pressures on prices stemming from weak demand." Id.

<sup>22</sup> See Arvind Krishnamurthy and Annette Vissing-Jorgensen, *The Ins and Outs of LSAPs*, Federal Reserve Bank of Kansas City Symposium on Global Dimensions of Unconventional Monetary Policy, at 57 (2013). (available at:

<https://www.kansascityfed.org/publicat/sympos/2013/2013Krishnamurthy.pdf>)

<sup>23</sup> Bank of Japan, Change in the Guideline for Money Market Operations (9 March 2006). (available at:

[http://www.boj.or.jp/en/announcements/release\\_2006/k060309.htm/](http://www.boj.or.jp/en/announcements/release_2006/k060309.htm/))

More specifically, the BOJ had the following understanding;

"Concerning prices, year-on-year changes in the consumer price index turned positive. Meanwhile, the output gap is gradually narrowing. Unit labor costs generally face[d] weakening downward pressures as wages began to rise amid productivity gains. Furthermore, firms and households are shifting up their expectations for inflation. In this environment, year-on-year changes in the consumer price index are expected to remain positive. The Bank, therefore, determined that the conditions laid out in the commitment had been fulfilled." Id.

The BOJ set the price stability target at two percent in terms of the year-on-year rate of change in the consumer price index (CPI) – "Price Stability Target" – and adopted the "Open-Ended Asset Purchasing Method" in January 2013.<sup>24</sup> In order to achieve this target, the BOJ entered into "a new phase" of monetary easing both in terms of quantity and quality in April 2013; "[i]t will double the monetary base and the outstanding amount of Japanese government bonds (JGBs) as well as exchange-traded funds (ETFs) in two years, and more than double the average remaining maturity of JGB purchases."<sup>25</sup> This is called "Quantitative and Qualitative Monetary Easing" (QQE).

On 29 January 2016, the BOJ decided to adopt "Quantitative and Qualitative Monetary Easing with a Negative Interest Rate."<sup>26</sup> Effective 16 February 2016, the BOJ applies a negative interest rate of minus 0.1 percent to a certain portion of the current accounts that financial institutions hold at the Bank.<sup>27</sup>

### 3.3.1 Theoretical aspects

Several significant features – which are common today among major

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<sup>24</sup> Bank of Japan, Introduction of the "Price Stability Target" and the "Open-Ended Asset Purchasing Method" (22 January 2013). (available at: [http://www.boj.or.jp/en/announcements/release\\_2013/k130122a.pdf](http://www.boj.or.jp/en/announcements/release_2013/k130122a.pdf)) Bank of Japan, The "Price Stability Target" under the Framework for the Conduct of Monetary Policy (22 January 2013). (available at: [http://www.boj.or.jp/en/announcements/release\\_2013/k130122b.pdf](http://www.boj.or.jp/en/announcements/release_2013/k130122b.pdf))

<sup>25</sup> Bank of Japan, Introduction of the "Quantitative and Qualitative Monetary Easing" (4 April 2013). (available at: [http://www.boj.or.jp/en/announcements/release\\_2013/k130404a.pdf](http://www.boj.or.jp/en/announcements/release_2013/k130404a.pdf))

<sup>26</sup> Bank of Japan, *supra* note 13.

<sup>27</sup> *Id.* More specifically, "the Bank will adopt a three-tier system in which the outstanding balance of each financial institution's current account at the Bank will be divided into three tiers, to each of which either a positive interest rate, a zero interest rate, or a negative interest rate will be applied." *Id.* For the details, see Bank of Japan, Framework for a Negative Interest Rate on Current Accounts at the Bank. (attachment of the same document, *id.*)

countries – had been observed earlier in Japan; the BOJ confronted the situation of "the liquidity trap" where the nominal interest rate became nearly zero and the central bank's conventional monetary policy had lost its effectiveness.<sup>28</sup> <sup>29</sup> As early as the 1990s, the BOJ was put under pressure for inventing a tool to attain its monetary policy purpose.

Academic studies submitted theoretical arguments to obtain a better understanding of transmission channels of monetary policy in the market, and examined the optimal level of commitment by the central bank.<sup>30</sup> As a

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<sup>28</sup> In this situation, standard Taylor-type feedback rules become inappropriate. See John B. Taylor, *Discretion versus policy rules in practice*, 39 Carnegie-Rochester Conference Series on Public Policy 195 (1993); Paul R. Krugman, *It's Baaack: Japan's Slump and the Return of the Liquidity Trap*, 2 Brookings Papers on Economic Activity 137 (1998). See also Jess Benhabib, Stephanie Schmitt-Grohe, and Martin Uribe, *Avoiding Liquidity Traps*, 110 (3) *Journal of Political Economy* 535 (2002); Lars E.O. Svensson, *Escaping from a Liquidity Trap and Deflation: A Foolproof Way and Others*, 17 (4) *Journal of Economic Perspectives* 145 (2003); Gauti B. Eggertsson and Michael Woodford, *The Zero Bound on Interest Rates and Optimal Monetary Policy*, 2003 (1) *Brookings Papers on Economic Activity* 139 (2003).

<sup>29</sup> For recent theories by BOJ economists, see Ippei Fujiwara, Tomoyuki Nakajima, Nao Sudo, Yuki Teranishi, *Global Liquidity Trap*, 60 *Journal of Monetary Economics* 936 (2013) (considering the problem of optimal monetary policy in a two-country world where both countries may confront the zero bound); Takushi Kurozumi, *Optimal Sustainable Monetary Policy*, 55 *Journal of Monetary Economics*, 1277 (2008) (examining a policymaker's strategy in the best sustainable equilibrium as "optimal sustainable" policy and showing that such a policy becomes consistent with the optimal commitment policy in sufficiently later periods). See also Taehun Jung, Yuki Teranishi and Tsutomu Watanabe, *Optimal Monetary Policy at the Zero Interest Rate Bound*, 37 *Journal of Money, Credit and Banking* 813 (2005) (addressing a central bank's intertemporal loss-minimization problem in which the non-negativity constraint on nominal interest rates is considered in order to clarify what should central banks do when they face a weak aggregate demand under the zero lower bound).

<sup>30</sup> For the view of the BOJ economists, see Kunio Okina and Shigenori Shiratsuka, *Policy Commitment and Expectation Formation: Japan's Experience Under Zero Interest Rates*, 15 *North American Journal of*

theoretical framework, however, the New Keynesian model was influential during the late 1990s, and the model typically assumed that the "zero lower bound" would not be a constraint on monetary policy and indicated that Japan's situation was an exception.<sup>31</sup> Most studies thus endeavored to generalize the specific situation and experiences in Japan, and develop a theoretical framework for such generalization.<sup>32</sup> <sup>33</sup> Recently, new theories have been presented to better explain the channels through which unconventional monetary policy affects asset prices and the real economy.<sup>34</sup>

### 3.3.2 Empirical analyses

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Economics and Finance 75 (2004) (analyzing the behavior of the yield curve and examining the effectiveness and limitations of monetary policy commitment under zero interest rate from March 1998 to February 2003). See also Hiroshi Fujiki, Kunio Okina, and Shigenori Shiratsuka, *Monetary Policy under Zero Interest Rate: Viewpoints of Central Bank Economists*, 19 (1) *Monetary and Economic Studies* 89 (2001).

<sup>31</sup> Richard Clarida, Jordi Galí and Mark Gertler, *The Science of Monetary Policy: A New Keynesian Perspective*, 37 *Journal of Economic Literature* 1661, at 1702 (1999).

<sup>32</sup> See, e.g., Takeshi Kimura and Takushi Kurozumi, *Endogenous nominal rigidities and monetary policy*, 57 *Journal of Monetary Economics* 1038 (2010) (considering the flattered Philips curve theoretically).

<sup>33</sup> After the sub-prime loans crisis in the US in August 2007, unconventional monetary policy in the form of QE or LSAPs has been deployed globally, first in a crisis time and then in "normal" times. Correspondingly, new models have been presented. See Mark Gertler and Peter Karadi, *A model of unconventional monetary policy*, 58 *Journal of Monetary Economics* 17 (2011). See also Mark Gertler and Peter Karadi, *QE 1 vs. 2 vs. 3...: A Framework for Analyzing Large-Scale Asset Purchases as a Monetary Policy Tool*, 9 (1) *International Journal of Central Banking* 5 (2013).

<sup>34</sup> See, e.g., Krishnamurthy and Vissing-Jorgensen, *supra* note 22 (pointing out three distinctive channels of LSAPs operations in normal times: signaling, capital constraints and scarcity channels). See also Arvind Krishnamurthy and Annette Vissing-Jorgensen, *The Effects of Quantitative Easing on Interest Rates: Channels and Implications for Policy*, 2011 (Fall) *Brookings Papers on Economic Activity* 215 (2011).

Empirical analyses on the BOJ's monetary policy abound.<sup>35</sup> <sup>36</sup> We note that for the analysis of monetary policy in Japan, there are peculiarities. In general, the Vector Autoregression (VAR) methodology is popularly deployed for examining the effectiveness of a monetary policy, and VAR in

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<sup>35</sup> Representative empirical studies in the 1990s are as follows. Bennett T. McCallum, *Japanese Monetary Policy, 1991-2001*, 89 (1) Federal Reserve Bank of Richmond Economic Quarterly 1 (2003); Shigeru Iwata and Shu Wu, *Estimating monetary policy effects when interest rates are close to zero*, 53 Journal of Monetary Economics 1395 (2006) (estimating the effects of exogenous monetary policy shock under the zero lower bound in Japan in a nonlinear VAR for the period from 1991 to 2001); Günter Coenen and Volker Wieland, *The zero-interest-rate bound and the role of the exchange rate for monetary policy in Japan*, 50 (5) Journal of Monetary Economics 1071 (2003) (quantifying the effect of the zero bound on stabilization performance in Japan from 1980 to 1998); Ryuzo Miyao, *The Effects of Monetary Policy in Japan*, 34 (2) Journal of Money, Credit and Banking 376 (2002) (analyzing the policy period from January 1975 to April 1998 with a recursive VAR methodology).

<sup>36</sup> Interesting discussions have been found internationally. See, e.g., R. Anton Braun and Etsuro Shioji, *Monetary Policy and the Term Structure of Interest Rates in Japan*, 38(1) Journal of Money, Credit, and Banking 141 (2006) (finding that the response of the yield curve depends on the maintained hypothesis about how monetary policy affects the economy); Naohiko Baba, Motoharu Nakashima, Yosuke Shigemi and Kazuo Ueda, *The Bank of Japan's Monetary Policy and Bank Risk Premiums in the Money Market*, 2 (1) International Journal of Central Banking 105 (2006) (by using the interest rates on negotiable certificates of deposit issued by individual banks, the authors showed that the levels of money market rates and the dispersion of rates across banks fell to near zero during the BOJ's ZIRP and QEP periods). See also Shigenori Shiratsuka, *Size and Composition of the Central Bank Balance Sheet: Revisiting Japan's Experience of the Quantitative Easing Policy*, 28 Monetary and Economic Studies 79 (2010).

For recent empirical studies in Japan, see e.g. Kazuo Ueda, *The Effectiveness of Non-traditional Monetary Policy Measures: The Case of the Bank of Japan*, 63 (1) Japanese Economic Review 1 (2012); Nobuyuki Oda and Kazuo Ueda, *The Effects of the Bank of Japan's Zero Interest Rate Commitment and Quantitative Monetary Easing on the Yield Curve: A Macro-Finance Approach*, 58 Japanese Economic Review 303 (2007).



its standard form assumes that time-series data regarding the economy have stationarity.<sup>37</sup> In Japan, however, structural changes in the economy during the 1990s probably made this condition unsatisfied.<sup>38</sup>

For this reason, empirical studies often adopted a research design other than VAR.<sup>39</sup> For example, Professor Kazuo Ueda, using a non-VAR approach, examined unconventional monetary policy measures by the BOJ during the period from the 1990s to the 2000s, and pointed out that many of those measures have moved asset prices in the expected direction, but most

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<sup>37</sup> For VAR in general, see Christopher Sims, *Macroeconomics and Reality*, 48 *Econometrica* 1 (1980); Lawrence J. Christiano, Martin Eichenbaum, and Charles L. Evans, *Monetary Policy Shocks: What Have We Learned and to What End?*, in John B. Taylor and Michael Woodford eds., *Handbook of Macroeconomics 1A*, 65 (Elsevier, 1999). See also James H. Stock and Mark W. Watson, *Vector Autoregressions*, 15(4) *Journal of Economic Perspectives* 101 (2001).

<sup>38</sup> E.g., Tomoo Inoue and Tatsuyoshi Okimoto, *Were there structural breaks in the effects of Japanese monetary policy? Re-evaluating policy effects of the lost decade*, 22 (3) *Journal of the Japanese and International Economies* 320 (2008) (employing block recursive structural VAR with Markov Switching for modelling monetary policy and showing that a major break in Japan's economy happened around 1996).

<sup>39</sup> It can also be possible to take this into account by adopting Markov Switching Vector Autoregressions (MSVAR). There are some empirical research along these lines. See Fumio Hayashi and Junko Koeda, *Exiting from QE*, NBER Working Paper, No. 19938 (2014). See also Inoue and Okimoto, *supra* note 38; Ippei Fujiwara, *Evaluating Monetary Policy When Nominal Interest Rates Are Almost Zero*, 20 *Journal of the Japanese and International Economies* 434 (2006) (estimating three identified Markov Switching VAR models for the period from January 1985 to December 2003 and clarifying the less effectiveness of the BOJ's monetary policy under the zero lower bound).

For MSVAR, see James Hamilton, *A new approach to the economic analysis of nonstationary time series and the business cycle*, 57 *Econometrica* 357 (1989). See also Hans-Martin Krolzig, *Markov-Switching Vector Autoregressions: Modelling, Statistical Inference, and Application to Business Cycle Analysis* (Springer, 1997).

of them failed to make yen (currency in Japan) weak.<sup>40</sup> Further, Professor Ueda pointed out that although those measures had some effects on asset prices, they failed to stop the deflationary trend in the Japanese economy.<sup>41</sup> Also, Professors Arvind Krishnamurthy and Annette Vissing-Jorgensen present an interesting explanation with a new theory and evidence of the channels through which LSAPs affect asset prices and the real economy.<sup>42</sup>

### 3.4 Future issues

We note two issues for future research and consideration. First, independence of the central bank is more important where the central bank's balance sheet is expanded through implementing its unconventional monetary policy; such expansion is often made by means of purchasing government bonds by the central bank. In this setting, the success of monetary policy depends on the central bank's credibility and the effectiveness of its strategy regarding announcements and communications.<sup>43</sup> <sup>44</sup> Central bank independence in the world of

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<sup>40</sup> Ueda, *supra* note 36, at 9-17.

<sup>41</sup> *Id.*, at 18-21.

<sup>42</sup> Krishnamurthy and Vissing-Jorgensen, *supra* note 22.

<sup>43</sup> Under the recent new framework for Monetary Policy Meetings, the BOJ "will provide, with higher frequency, more detailed forecasts for Japan's economy and prices, which serve as the basis of policy decisions." More specifically, this includes; "(1) forecasts for the economy and prices are released on a quarterly basis, (2) meetings on monetary policy are held eight times a year, that is, four meetings for forecasts and four other meetings in between these, and (3) a summary of discussion at each MPM is released quickly" as widely adopted by major central banks. Bank of Japan, *supra* note 7.

<sup>44</sup> See, e.g., Alan S. Blinder, Michael Ehrmann, Marcel Fratzcher, Jakob De Hann, and David-Jan Jansen, *Central Bank Communication and Monetary Policy: A Survey of Theory and Evidence*, 46 (4) *Journal of Economic Literature* 910 (2008). See also, Ippei Fujiwara, *Is the central bank's publication of economic forecasts influential?*, 89 (3) *Economics Letters* 255 (2005) (showing that while a central bank's economic forecasts are not significantly influenced by those of professional forecasters, the latter are notably affected by the former); Kozo Ueda, *Central Bank Communication and Multiple Equilibria*, 6 (3) *International Journal of*

democracy would thus be more important than ever, and it must be ensured legally and institutionally.<sup>45</sup> How exactly the current legal and institutional setting for the BOJ under the BOJ's Act affects the BOJ's unconventional monetary policy has not been studied in much depth yet and waits for future research.

Second, despite the vast amount of empirical studies, the transmission mechanism of announcements by a central bank and how they affect expectations in the market place have not been sufficiently clear. These should also be relegated for future research.

#### **4. Prudential policy: On-site examinations by the BOJ<sup>46</sup>**

The BOJ carries out a unique prudential policy in developed countries. Specifically, the BOJ undertakes inspections of its counterparty financial institutions, and check their business operations and the state of their assets by visiting their premises. This is called "on-site examinations." Although this is a key procedure for the BOJ to monitor financial institutions, literature regarding this is scarce.

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Central Banking 145 (2010) (constructing a simple model for communications between a central bank and money-market traders, and found that too-much transparency in central banks is not desirable); Yoshiyuki Nakazono and Kozo Ueda, *Policy commitment and market expectations: Lessons learned from survey evidence under Japan's quantitative easing policy*, 25-26 *Japan and the World Economy* 102 (2013) (by using the survey on interest rate and inflation expectations, the authors estimated the effects of the BOJ's policy commitment on market expectations by focusing on the QEP).

<sup>45</sup> Traditionally, see Alan S. Blinder, *Central Banking in a Democracy*, 82 (4) *Federal Reserve Bank of Richmond Economic Quarterly* 1 (1996). See also *supra* note 8.

<sup>46</sup> This section draws on Toshiaki Yamanaka, *On-site Examinations by the Bank of Japan: Recent research development and future issues*, 33 *Kinyu Kozo Kenkyu* 1 (2011). For an official explanation of on-site examinations by the BOJ, see the Institute for Monetary and Economic Studies, Bank of Japan, *supra* note 3, at 160-182.

## 4.1 An overview of on-site examinations

In Japan, regulatory power over financial institutions is given to the government, and for most financial institutions, the Financial Services Agency (FSA) is the national regulator. Prudential policy in Japan thus is implemented by both the FSA and the BOJ.

Auditing by the FSA is based on the Banking Act (Act No. 59 of 1981) and other laws. As a regulatory authority, the FSA exercises power to carry out on-site inspections and to make mandatory requests for financial institutions to provide materials.

In contrast, on-site examinations by the BOJ have been based on private contracts (known as "on-site examinations agreement[s]")<sup>47</sup> between the BOJ and its counterparty financial institutions since their inception as early as 1928.<sup>48</sup> Accordingly, the BOJ obtains consent of the financial institutions from phase to phase in carrying out on-site examinations. There was no explicit provision regarding this under the old BOJ Act, but the new BOJ Act in 1997 introduced Article 44 (see Section 2.4.1 above).<sup>49</sup>

## 4.2 Legal framework and enforcement

Under the on-site examinations agreement ("the Agreement"), two steps must be taken before on-site examinations are conducted. First, the BOJ must make an offer to the financial institution; "[i]n the event that it deems it necessary to conduct on-site examinations of the Financial Institution, the BOJ shall first present the objectives, scope and dates of the on-site examinations to the Financial Institution, and ask for its consent thereto"

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<sup>47</sup> The model of this "on-site examinations agreement" [hereinafter, referred to as "the Agreement"] was determined in February 1998. (available at: [https://www.boj.or.jp/finsys/exam\\_monit/touyo02.htm/](https://www.boj.or.jp/finsys/exam_monit/touyo02.htm/)) (in Japanese) (English translation is available at: [https://www.boj.or.jp/en/finsys/exam\\_monit/kei01.pdf](https://www.boj.or.jp/en/finsys/exam_monit/kei01.pdf))

<sup>48</sup> See Yamanaka, *supra* note 46, at 3.

<sup>49</sup> Before Article 44 was introduced, on-site examinations had been understood as based on a general provision under the old BOJ Act.

(Article 3 (1) of the Agreement). Then, the financial institution must respond to the offer; "[u]pon receipt of the offer from the BOJ to conduct the on-site examinations pursuant to the preceding Article, the Financial Institution shall respond to the BOJ as to its consent or refusal in a timely manner" (Article 4 (1) of the Agreement).

In the course of on-site examinations, the BOJ has the right to request information from the financial institution; "[i]n the course of the on-site examinations the BOJ may request the Financial Institution to explain its business operations and financial condition in order to achieve the objectives of the on-site examinations" (Article 8 (1) of the Agreement). The financial institutions may refuse to provide information if there is a "legitimate reason"; "[t]he Financial Institution may refuse the provision of information pursuant to Article 8 or Article 9 for legitimate reasons" (Article 10 of the Agreement).<sup>50</sup>

Where a breach of obligations by the financial institution is found, the BOJ may take two actions. First, the BOJ may announce the breach to the general public, which includes the breach of the obligation to provide information (Article 13 of the Agreement).<sup>51</sup> Second, the BOJ may terminate its current account deposit relationship with the financial institution in the event that the financial institution breaches the obligation to provide information or other obligations (Section 2 of Article 19 of Touza Kanjo Kitei (current account agreement)<sup>52</sup> and Article 13 (3) of the Agreement).<sup>53</sup>

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<sup>50</sup> The notion "legitimate reason" may be unclear. "In such circumstances, the Financial Institution shall consult with the BOJ in the event that the BOJ requests consultation with the Financial Institution regarding other applicable methods in lieu of the said provision of information" (Article 10 of the Agreement).

<sup>51</sup> In practice, 13 cases were published by the BOJ for the period from 1999 to 2015. Bank of Japan, Kousa Kinyu Kikan Keiei (available at: [http://www.boj.or.jp/finsys/exam\\_monit/index.htm/](http://www.boj.or.jp/finsys/exam_monit/index.htm/)) (in Japanese).

<sup>52</sup> Bank of Japan, Touza Kanjo Kitei (available at: <https://www.boj.or.jp/paym/torihiki/touyo08.htm/>) (in Japanese).

<sup>53</sup> The right to publish the fact that the BOJ terminated current account deposits on the basis of the breach of the Agreement is not stipulated in the

### 4.3 Future issues

In the above, we have briefly introduced core legal aspects of on-site examinations by the BOJ.<sup>54</sup> We note three issues for future consideration.

First, in theory, the wisdom that the BOJ – or central banks generally – carry out prudential policy is not entirely clear.<sup>55</sup> Second, in the same vein, it is important to clarify the essential role and functions of on-site examinations, in connection with the lender of last resort or their macroprudential function. Finally, power to undertake on-site examinations should perhaps be recognized by statute rather than by contract.<sup>56</sup>

### 5. Conclusion

As in the past, world financial markets today are in a state of flux. As a result, the environment surrounding central banks changes every day. The

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Agreement. We found no case that has been published.

<sup>54</sup> There are other aspects of on-site examinations. The BOJ started publishing "On-site Examination Policy" at around the beginning of every fiscal year from 1999 – the initial title used to be "Principles for On-site Examination and Off-site Monitoring" for 1999 and 2000. Bank of Japan, On-Site Examination Policy (available at: [https://www.boj.or.jp/en/finsys/exam\\_monit/exampolicy/index.htm/](https://www.boj.or.jp/en/finsys/exam_monit/exampolicy/index.htm/)). These contributed to transparency regarding on-site examinations under the BOJ Act.

<sup>55</sup> Discussions abound on this issue. See Bank for International Settlements, *supra* note 8 (Central bank governance and financial stability); Charles A.E. Goodhart, *The Regulatory Response to the Financial Crisis* (Edward Elgar, 2009); Lastra, *supra* note 5 (International Financial and Monetary Law), at 111-146. More recently, see, e.g., Stephen G. Cecchetti, *On the separation of monetary and prudential policy: How much of the precrisis consensus remains?*, 2015 *Journal of International Money and Finance* 1 (2015) (showing that the precrisis consensus – monetary policymakers and prudential authorities had clearly defined tools and goals with little or no conflict – remains largely intact after the financial crisis).

<sup>56</sup> See Kanda, *supra* note 3, at 21-22.

activities and functions of central banks around the world are highly contingent on their historical, political and macroeconomic landscape.

Professor Raghuram Rajan, currently the Governor of the Reserve Bank of India, states:

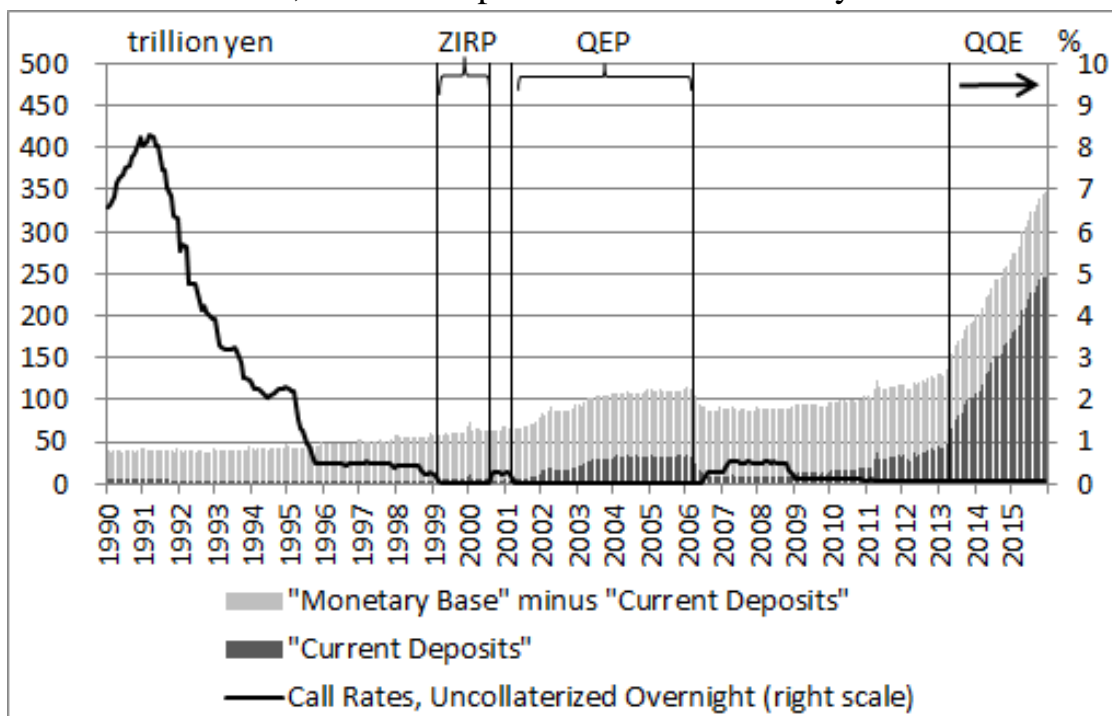
"Political economy is embedded in everything we do, though much of our work is based on a technical framework, with models, forecasts and a very specific mandate. I'll argue that there is a reason for our techno-centric emphasis, but the reality of central banking is that our historical experience, as well as the current political environment, does influence the emphasis we place on various aspects of our framework."<sup>57</sup>

How legal and institutional settings for the central bank and its governance structure interact with the bank's monetary policy and macroprudential policy in Japan as well as in other regions continues to be an interesting academic inquiry, and calls for further research agenda.

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<sup>57</sup> Raghuram Rajan, Remarks at the Jackson Hole Economic Policy Symposium, Federal Reserve Bank of Kansas City (29 August 2015). (available at: <https://www.kansascityfed.org/~media/files/publicat/sympos/2015/econsymposium-rajan-remarks.pdf?la=en>)

Chart 1. Call Rates, Current Deposits and the "Monetary Base"



Source: BOJ Time-Series Data Search at BOJ's website ([http://www.stat-search.boj.or.jp/index\\_en.html](http://www.stat-search.boj.or.jp/index_en.html)). The names are; 1) "Call Rates, Uncollateralized Overnight/Average" (code: ST'STRACLUCON), 2) "Monetary Base/Average Amounts Outstanding" (code: BJ'MABS1AN11), and 3) "Monetary Base/Current Account Balances/Average Amounts Outstanding" (code: BJ'MABS1AN113).