THE LIMITS OF STATUTORY INDEPENDENCE: THE BANK OF JAPAN AND THE POLITICS OF MONETARY POLICY

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ABSTRACT

The theory of central bank independence (CBI) is predicated on providing central bankers with political insulation that would allow them the latitude to take tough measures to "take away the punch bowl," thereby enhancing their ability to control inflation. Driven by theory, the history of high inflation, and politics, CBI diffused relatively rapidly, including to the Bank of Japan (BOJ) in the late 1990s. In this paper, we use the case of Japan to illustrate the political limits of statutory independence and demonstrate how the degree of *de facto* independence can vary over time with no legal changes. Specifically, we highlight how the BOJ lost a degree of *de facto* independence with no *de jure* change due to two distinct processes: an electoral process that allowed the government to win a mandate and appoint new Policy Board Members to reorient monetary policy, and structural politicization resulting from greater intervention in asset prices.

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INTRODUCTION

The economic theory underpinning central bank independence (CBI) rests on the assumption that specific political incentives introduce an inflationary bias.[1] Governments have political incentives to stimulate the economy over the short-term, but if relied on repeatedly, such a policy will generate longer term inflation.[2] Thus, monetary policymaking faces the challenge of the time inconsistency problem in which short-term political incentives produce less desirable longer-term outcomes, specifically inflation. According to the theory of CBI, the principal (the government) can partly solve this problem by delegating monetary policy authority to an agent, an independent central bank.[3] By doing so, governments tie their own hands, allowing an independent central bank the space to take less popular measures to keep inflation in check.[4] This institutional change confers on central banks greater credibility in fighting inflation.

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1 *See generally* Finn E. Kydland & Edward C. Prescott, *Rules Rather Than Discretion: The Inconsistency of Optimal Plans*, 85 J. POL. ECON. 473 (1977).

2 *Id.*; *see* Robert J. Barro & David B. Gordon, *Rules, Discretion and Reputation in a Model of Monetary Policy*, 12 J. MONETARY ECON. 101 (1983).

3 Kenneth Rogoff, *The Optimal Degree of Commitment to an Intermediate Monetary Target*, 100 Q.J. ECON. 1169, 1169–70 (1985); Alberto Alesina, *Macroeconomics and Politics*, 3 NBER MACROECONOMICS ANN. 13, 42 (1988).

4 Alesian, *supra* note 3, at 16-19.

While there is substantial evidence that CBI does lower inflation,[5] some have challenged: (1) that CBI does not lower inflation, and (2) that the extent to which legal changes confer independence is limited. Posen, for instance, argues that it is not CBI per se that causes lower inflation but rather CBI is endogenous to the preferences of key societal groups.[6] Forder questions the extent to which statutory independence really drives the behavior of central bankers.[7]

Other researchers have focused on the many channels that governments maintain to influence central banks.[8] While most CBI statutes include provisions that specify set terms and insulate central bankers from arbitrary dismissal, in most cases it is governments that nominate central bankers and the legislatures that confirm them.[9] Since central banker terms come to an end regularly, even within the bounds of CBI, governments can influence the composition of monetary policymakers, although how much influence depends on the timing of terms and the length of time that an executive stays in office.[10]

Evidence suggests that governments can and do influence monetary policy. Adolph finds that governments tend to appoint central bankers with monetary policies in line with their ideological positions.[11] In the United States context, the presidential power to appoint Federal Open Market Committee members has been found to be the primary channel to align monetary policy with the executive's partisan

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5 *Id.* at 16, 30; Alex Cukierman et al., *Measuring the Independence of Central Banks and its Effect on Policy Outcomes*, 6 WORLD BANK ECON. R. 353, 367–70 (1992); Alberto Alesina & Lawrence H. Summers, *Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence*, 25 J. MONEY, CREDIT AND BANKING 151, 151–53 (1993); Sylvester C.W. Eijffinger & Jakob De Haan, *The Political Economy of Central-Bank Independence*, SPECIAL PAPERS INT'L ECONS., May 1996 at 1, 1.

6 Adam Posen, *Why Central Bank Independence Does Not Cause Low Inflation: There Is No Institutional Fix For Politics*, *in* 7 FIN. & INT'L ECON.: AMEX BANK REV. PRIZE ESSAYS 40, 41–42 (1993).

7 James Forder, *Central Bank Independence: Reassessing the Measurements*, 33 J. ECON. ISSUES 23, 23 (1999).

8 Thomas R. Cusack, *Partisanship in the Setting and Coordination of Fiscal and Monetary Policies*, 40 EUR. J. POL. RSCH. 93, 95–98 (2001); J. Lawrence Broz & William R. Clark, *Voting to Audit the Fed*, SSRN ELECTRONIC J., Apr. 19, 2018, at 2, SSRN 3154594; *see also* ROBERT ELGIE & HELEN THOMPSON, THE POLITICS OF CENTRAL BANKS (Taylor & Francis ed., Routledge 2012) (1998); Manabu Saeki & Steven A. Shull, *Who Influences the Fed? Presidential Versus Congressional Leadership*, 23 J. PUB. POL'Y 261, 261–62 (2003).

9 Ashraf Khan, *Legal Protection: Liability and Immunity Arrangements of Central Banks and Financial Supervisors*, 10, 15 (IMF Working Paper No. 18-176, 2018).

10 Cukierman et al., *supra* note 5, at 367.

11 CHRISTOPHER ADOLPH, BANKERS, BUREAUCRATS, AND CENTRAL BANK POLITICS: THE MYTH OF NEUTRALITY 226 (Cambridge Univ. Press ed. 2013).

preferences.[12] If a government or legislature feels that a central bank has deviated too far from its preferences, it can signal its displeasure. Legislators can summon central bankers and subject central bankers to questioning.[13] Politicians can also threaten legislation to curtail CBI, as members of the United States Congress frequently do through supporting "Audit the Fed" legislation.[14] In the most extreme case, a government can abolish CBI. Given these levers, there are strong incentives for central banks to respond to elected officials,[15] and there is evidence that they do.[16]

In this Article, we use the case of the Bank of Japan to highlight two other factors that can shape the level of *de facto* independence, the degree of independence a central bank exercises in practice, in the context of statutory independence: the electoral process and the structural politicization that results from larger monetary policy interventions.

I. JAPAN'S ADOPTION OF CBI

The Japanese government established *de jure* or legal central bank independence with the passage of the 1998 Bank of Japan Law. One interesting aspect of the BOJ's transition to independence is that it cannot be attributed to either high inflation or monetary policy failures. Indeed, Japanese economic policymakers had an exemplary record in keeping inflation in check. Cargill et al. point out that of nineteen industrialized countries, Japan had the lowest average inflation rate between 1975 and 1996, despite having one of the most dependent central banks,[17] a puzzle that has drawn the attention of scholars. Moreover, during the deliberation and then passage of the law, Japan was in fact experiencing very low inflation which then turned to deflation by the latter half of 1998.[18] The BOJ's monetary policy track-record came under criticism during the 1990s. Critics argued the BOJ's excessively loose monetary policy during

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12 Henry W. Chappell, Jr. et al., *Partisan Monetary Policies: Presidential Influence Through the Power of Appointment*, 108 Q.J. ECONS. 185, 186 (1993).

13 Gene Park et al., *Asymmetric Incentives and the New Politics of Monetary Policy*, 20 SOCIO-ECON. REV. 733, 742 (2022).

14 *See* Broz & Clark, *supra* note 8, at 2–3.

15 *See generally* William Roberts Clark & Vincent Arel-Bundock, *Independent but not Indifferent: Partisan Bias in Monetary Policy at the Fed*, 25 ECON. & POL. 1 (2013).

16 THOMAS HAVRILESKY, THE PRESSURES ON MONETARY POLICY 14 (1993).

17 THOMAS F. CARGILL ET AL., FINANCIAL POLICY AND CENTRAL BANKING IN JAPAN 111 (MIT Press 2001).

18 GENE PARK ET AL., TAMING JAPAN'S DEFLATION: THE DEBATE OVER UNCONVENTIONAL MONETARY POLICY 85 (Cornell Univ. Press 2018).

the latter half of the 1980s fed the asset bubble, then, after the bubble burst, the BOJ was too slow to lower rates, thus exacerbating the recession.[19] These critiques, however, did not drive the reform process, and, as Cargill et al. note: "The 1998 revision had little to do with dissatisfaction over past monetary policy."[20]

An approaching election explains the timing of the new BOJ law in the second half of the 1990s as the government set out to demonstrate its willingness to "embrace international standards in its efforts to restore financial economic vitality" and "regain the confidence of domestic and international market participants."[21] From the view of reformers, the best way to establish credibility for the central bank was to model the new BOJ as closely conforming to international best practice.[22] By the 1990s, CBI had become an international norm. Academic studies dating back to the 1980s established an empirical relationship between inflation and statutory CBI, and scholars provided further empirical support during the 1990s such that the value of CBI became a conventional wisdom and "the global standard."[23]

The new acceptance by the global community provided impetus for change; domestic actors translated these ideas into policy. In the case of Japan, however, the key actors were not economic interest groups; rather, the "demanders" of CBI were policy experts and the Liberal Democratic Party (LDP).[24] While the norm of CBI provided an economic justification (despite the fact that Japan had no problem with inflation), CBI succeeded because the idea found supporters in the ruling LDP. Pro-CBI reformers found a receptive supporter in the LDP in part because of the declining reputation of Japan's Ministry of Finance (MOF), which had authority over the BOJ.[25] Over the course of the 1990s, MOF was blamed for economic stagnation, criticized for its handling of the financial system (including non-performing loans and the bailout of housing loan

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[19] ADAM SIMON POSEN, RESTORING JAPAN'S ECONOMIC GROWTH 21 (1998).

[20] CARGILL, *supra* note 17, at 112.

[21] Jennifer Holt Dwyer, *Explaining Central Bank Reform in Japan*, 7 SOC. SCI. JAPAN J. 245, 246 (2004).

[22] *Id.* at 257.

[23] Kathleen McNamara, *Rational Fictions: Central Bank Independence and the Social Logic of Delegation*, 25 W. EUR. POL. 47, 49 (2002); Lucia Quaglia, *An Integrative Approach to Politics of Central Bank Independence: Lessons from Britain, Germany and Italy*, 28 W. EUR. POL. 549, 551 (2005).

[24] Dwyer, *supra* note 21, at 255.

[25] WILLIAM W. GRIMES, UNMAKING THE JAPANESE MIRACLE: MACROECONOMIC POLITICS, 1985-2000 216 (2001).

companies), and targeted by politicians for a number of corruption scandals.[26] As a result, MOF, usually a formidable political force, became an easy target for politicians wanting to score political points for delivering "reform." Indeed, the political attacks on MOF went well beyond granting the BOJ independence and even included the consideration of taking the budgeting functions from the Ministry.[27] It did not help MOF that leaders in the LDP viewed MOF as having been too cooperative with the previous government, which had excluded the LDP.[28] In short, the politics of CBI ultimately had little to do with the objective of CBI—achieving greater inflation control.

A. The New Bank of Japan Law and CBI

Prior to the new Bank of Japan Law, the BOJ had little legal independence.[29] Under the old BOJ Law of 1942, the cabinet had the authority to dismiss the governor and vice governors, while the minister of finance could remove other officials such as executive directors, auditors, and advisers.[30] Additionally, the BOJ Law of 1942 lacked a specific directive, such as ensuring price stability, which allowed the executive branch significant discretion in dismissing BOJ personnel.[31] One comparative index of the level of CBI found that the BOJ had near the lowest degree of independence of the industrial democracies, ranking just nineteenth of twenty-one countries.[32]

In contrast to the Bank of Japan Law from 1942, the new Bank of Japan Law of 1998 specified clearer goals. Whereas previously the law mentioned enhancing the "general economic activities of the nation,"[33] the new law establishes clear objectives. Article 1 specifies two goals: "to issue banknotes and to carry out currency and monetary control" and

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26 *Id.* at 202.

27 GENE PARK, SPENDING WITHOUT TAXATION: FLIP AND THE POLITICS OF PUBLIC FINANCE IN JAPAN 80 (2011).

28 *See generally* CARGILL, *supra* note 17.

29 *See* Cukierman et al., *supra* note 5, at 362.

30 Gene Park, *The Bank of Japan: Central Bank Independence and the Politicization of Monetary Policy*, *in* THE OXFORD HANDBOOK OF JAPANESE POLITICS 432, 434 (Robert J. Pekkanen & Saadia M. Pekkanen eds., Oxford University Press 2021).

31 *Id.*

32 Cukierman et al., *supra* note 5, at 380.

33 *Outline of the Bank*, BANK OF JAPAN, https://www.boj.or.jp/en/about/outline/index.htm [https://perma.cc/F6JA-SKL2] (noting The Act of 1942 strongly reflected the wartime situation of the time).

"ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of stability of the financial system."[34] Article 2 stipulates specifically that currency and monetary control should work to achieve price stability.[35] Notably, neither economic growth nor employment were included in the law, suggesting that the priority is price stability, although Article 2 adds that policy should contribute "to the sound development of the national economy."[36]

Under the new BOJ law, autonomy is established through several means. First, the new law clearly states that the autonomy of the BOJ should be respected by the government.[37] In addition, the new law created an independent Policy Board[38] consisting of nine members[39] that make decisions "concerning currency and monetary control."[40] These include a governor and two deputy governors.[41] In addition, the Policy Board includes six non-executive members.[42] The Cabinet nominates candidates, who must be approved by both chambers of the Diet, Japan's legislature.[43] Board members serve five-year terms, and during this time they are protected from dismissal,[44] a protection that did not exist under the old law. In addition, the BOJ now develops its own budget.[45] The MOF reviews and authorizes the budget.[46] If the MOF chooses not to authorize the budget, it must publicly disclose its reasons for doing so,[47] and the BOJ can air its views to the public and MOF.[48] Regarding relations with the government, the minister of finance and the minister of state for economic and fiscal policy or another representative from those ministries can attend

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34 Nipponginkōhō [Bank of Japan Act], Act No. 89 of 1997, art. 1, *translated in* (Japanese Law Translation [JLT DS]) ("The Bank of Japan Act (Act No. 67 of 1942) is fully amended") https://www.japaneselawtranslation.go.jp/en/laws/view/3788/en [https://perma.cc/BB79-CRJB].

35 *Id.* at art. 2.

36 *Id.*

37 *Id.* at art. 3.

38 *Id.* at art. 14.

39 *Id.* at art. 16, para. 1.

40 *Id.* at art. 15, para. 1.

41 *Id.* at art. 16, para. 2.

42 *Id.*

43 *Id.*

44 *Id*. at art. 25.

45 *Id*. at art. 51.1.

46 *Id.*

47 *Id*. at art. 51.2.

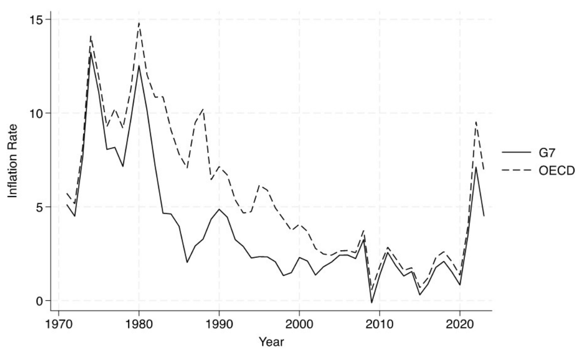
48 *Id*. at art. 51.3.

Policy Board meetings and present their views, but they cannot vote.[49] They can request a delay on a policy decision,[50] but there is no obligation for the Policy Board to accept it.[51]

B. Changing Inflationary Conditions

Among the advanced industrial countries, the inflation rate steadily declined starting from the 1980s until the start of the pandemic as shown in Figure 1. Coined as the "great moderation" by a former Federal Reserve chair Ben Bernanke,[52] this extended period of low inflation persisted until the onset of the COVID pandemic. While deflation, characterized by price decreases, was relatively uncommon, countries such as Canada, Germany, Norway, and Sweden encountered brief episodes of deflation. Japan, though, experienced deflation for a much longer period. During the 2008 Global Financial Crisis (GFC), however, several other regions experienced deflation and very low inflation (such as the United States and Eurozone). The period of low inflation ended during the COVID pandemic and Russian invasion of Ukraine, as supply chain problems led to higher inflation.

Figure 1
Core Inflation Rate, G7 and OECD



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[49] *Id*. at art. 19.1, 19.2, 19.3.

[50] *Id*. at art. 19.2.

[51] *Id*.

[52] Ben S. Bernanke, *Governor, Fed. Reserve Board, Remarks by Governor Ben S. Bernanke At the meetings of the Eastern Economic Association, Washington, DC* (Feb. 20, 2004).

[53] Main Economic Indicators, OECD iLibrary.

Figure 2
Core Inflation Rate, USA and Euroarea
Monthly year-on-year

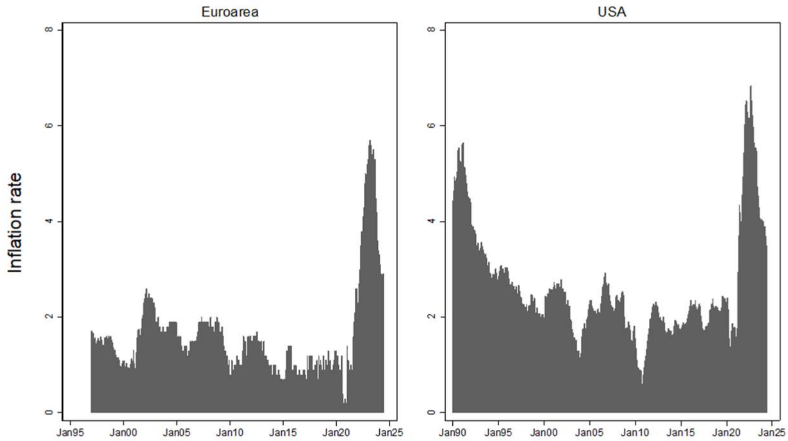

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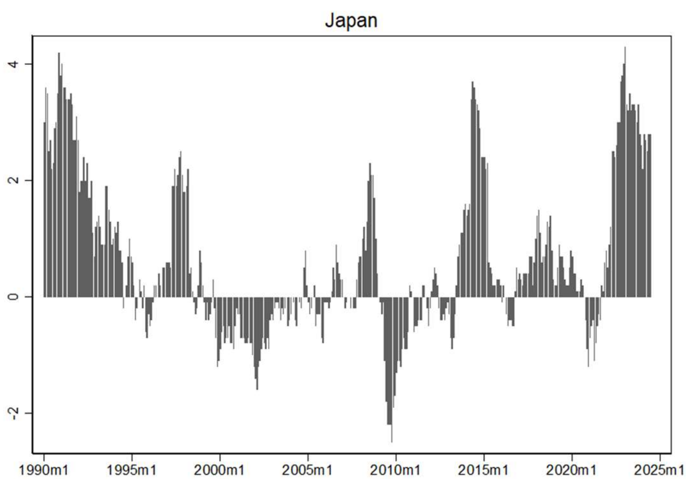
Figure 3
Inflation rate, Japan Monthly year-on-year



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[54] Main Economic Indicators, OECD iLibrary.

[55] Statistics of Japan, E-Stat, Consumer Price Index, https://www.e-stat.go.jp/en/stat-search?page=1&toukei=00200573 [https://perma.cc/5A2N-XQNS].

Comparing Figures 2 and 3, Japan's situation stands out due to the frequency of its deflation. The timing of the new BOJ Law, which established *de jure* independence, coincided ironically with the start of deflation. The Japanese economy, grappling with a prolonged financial crisis in the wake of an asset bubble collapse starting at the very end of the 1980s,[56] had already experienced a brief period of mild deflation in late 1995 and early 1996.[57] Then, just a few months after the new BOJ Law came into effect in April of 1998, deflation returned and persisted for long periods until 2013.[58] This new price environment, discussed in more detail in the next section, is one of the key factors that led to declining *de facto* CBI. To provide context, this section details an overview of Japan's low inflation and deflationary environment through the start of 2013.

When the new BOJ Law took effect, Japan's slowly unfolding financial crisis was coming to a head.[59] Towards the end of 1997, though, two major financial institutions—Hokkaido Takushoku Bank and Yamaichi Securities—collapsed, leading to greater stress in Japan's financial system at a time that coincided with an external shock.[60] The Asian Financial Crisis, which began as a currency crisis in Thailand, quickly spread rapidly to Indonesia, South Korea, and eventually to Russia and Brazil.[61] As fears of a Japanese financial crisis grew, the government intervened with a large package to help cover losses in the deposit insurance system and provide capital injections to support banks, but recapitalization of banks was handled poorly.[62] The government remained reluctant to take firm measures to force banks to write off non-performing loans and rebuild their balance sheets, greatly prolonging the financial crisis.[63] Only with the appointment of Heizo Takenaka as minister of state for financial services and then the implementation of the Takenaka Plan

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56 *See* GRIMES, *supra* note 25.

57 *See* Figure 3.

58 *Id.*

59 *See* GRIMES, *supra* note 25, at 190.

60 *Id.*

61 Jeffery D. Sachs & Wing Thye Woo, *Lessons From the Asian Financial Crisis*, *in* THE ASIAN FINANCIAL CRISIS: LESSONS FOR A RESILIENT ASIA 3, 3, fn 3 (Wing Thye Woo, Jeffrey D. Sachs & Klaus Schwab Ed., 2000); Jeffrey D. Sachs & Wing Thye Woo, *The Asian Financial Crisis: What Happened, and What Is to Be Done*, *in* THE ASIA COMPETITIVENESS REPORT 1999 (Geneva: World Economic Forum, 1999).

62 CARGILL, *supra* note 17, at 26-27.

63 Masami Imai, *Regulatory Responses to Banking Crisis: Lessons from Japan*, 39 GLOB. FIN. J. 10, 11 (2019).

was the banking problem finally addressed.[64] The prolonged recession was caused by a combination of factors: the delayed resolution of the banking crisis, the economic shock from the collapse of technology stock prices between 2000 and 2001, and policy missteps, such as the consumption tax increase in April 1997 and the premature tightening of monetary policy in August 2001.[65] Deflation began in mid-1998 and persisted, with some brief inflationary periods, until the mid-2000s.[66]

The resolution of the non-performing loans, recapitalization of the banks, monetary easing, and global economic growth contributed to a period of economic growth and pulled the economy out of deflation as shown in Figure 2. By 2007, however, the GFC that emanated from sub-prime lending in the United States housing market and the securitization of those loans began to spread to institutions holding those assets, causing a global liquidity crisis and the most severe recession since the Great Depression.[67] Although Japanese financial institutions were less exposed to the sub-prime crisis, the economy suffered a sharp recession, more severe than the United States or Europe.[68] Furthermore, Japan slipped back into deflation with prices declining at the most rapid rate since Japan's first bout of deflation in the mid-1990s.[69] Deflation persisted intermittently through mid-2013, far longer than it persisted in the United States or the Eurozone as seen in Figure 2. During this time, Japan experienced yet another economic shock caused by a massive earthquake on March 11, 2011, which triggered a tsunami and a nuclear meltdown.[70]

By mid-2013, deflation dissipated, and Japan maintained a positive inflation rate until the onset of the global pandemic, which triggered a sharp economic contraction and short period of deflation.[71] The

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[64] *Id.* at 14.

[65] Takatoshi Ito & Frederic S. Mishkin, *Two Decades of Japanese Monetary Policy and the Deflation Problem*, 15 MONETARY POL'Y WITH VERY LOW INFLATION IN THE PAC. RIM 131, 131–132 (2019).

[66] *See* Figure 3.

[67] Sheldon Danziger, *Evaluating the Effects of the Great Recession*, 650 THE ANNALS OF THE AM. ACAD. POL. AND SOC. SCI. 6, 6–8 (Sheldon Danziger ed., 2013).

[68] Hugh Patrick, *Japan's Deep Recession and Prolonged Recovery*, CENTER ON JAPANESE ECONOMY AND BUSINESS ANNUAL REPORT 2008-2009, 2, 2.

[69] *See* Figure 3.

[70] Kenneth Neil Cukier, *The Economic Fallout: Japan's Post-3/11 Challenges*, *in* NATURAL DISASTER AND NUCLEAR CRISIS IN JAPAN: RESPONSE AND RECOVERY AFTER JAPAN'S 3/11 223, 223 (Jeff Kingston Ed., 2012).

[71] Jens H.E. Christensen, James M. Gamble IV & Simon Zhu, *Coronavirus and the Risk of Deflation*, FED. RSRV. BANK OF S.F. (May 11, 2020), https://www.frbsf.org/research-and-

effect was similar in the Eurozone, while the United States experienced very low inflation.[72] The pandemic then led a sharp uptick in prices due to disruptions to the supply chain, economic stimulus, and, in Japan's case, depreciation of the yen, which raised import prices.[73] Prices then settled near the BOJ's target of 2 percent annual inflation by 2024.[74]

II. THE POLITICS OF ECONOMIC STAGNATION

The roots of the BOJ's diminishing *de facto* independence originate with dissatisfaction with the BOJ's monetary policy and, increasingly, over time, its lackadaisical approach to deflation.[75] In brief, the BOJ, partly shielded by its statutory independence, pursued policies often at odds with the government. Over time, politicians and many economists argued that deflation was not merely reflective of economic stagnation but a cause of it, and that monetary policy should prioritize reflating the economy.[76] Ultimately, the LDP campaigned on overcoming deflation and using monetary policy to do so.[77] Then, as discussed in the next section, the LDP-led government, under the leadership of former Prime Minister Shinzo Abe, appointed new leadership at the BOJ that would follow its mandate.

At first, deflation was not seen as an urgent problem by the public or most politicians. Indeed, surveys suggested that, on balance, voters did not mind deflation; research has shown that legislators worried more about inflation compared to deflation.[78] Overall, the Policy Board also took a

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insights/publications/economic-letter/2020/05/coronavirus-and-risk-of-deflation [https://perma.cc/Q2YH-BY9K].

[72] Graeme Wearden, *Eurozone now in its longest recession*, THE GUARDIAN (May 15, 2013), https://www.theguardian.com/business/2013/may/15/eurozone-recession-deepens#:~:text=The%20eurozone%20has%20slumped%20into%20its%20longest,2013%2C%20statistics%20body%20Eurostat%20reported%20on%20Wednesday [https://perma.cc/2KSG-5RV9].

[73] Robin Brooks et al., *COVID-19 Was a Supply Shock,* BROOKINGS (Aug. 15, 2024), https://www.brookings.edu/articles/covid-19-inflation-was-a-supply-shock/ [https://perma.cc/Q58V-N78C]; Willem Thorbecke, *Navigating the Economic Shifts of Yen Depreciation in Japan,* EAST ASIA F. (2024).

[74] Makiko Yamazaki & Satoshi Sugiyama, *Japan's Core Inflation Picks up, but Demand-Driven Growth below 2%,* REUTERS: ASIAN MARKETS (August 23, 2024), https://www.reuters.com/markets/asia/japans-core-inflation-picks-up-july-demand-driven-growth-below-2-2024-08-23/ [https://perma.cc/MWJ6-RFWM].

[75] Park et al., *supra* note 18, at 29–30.

[76] *Id.* at 28–30.

[77] *Id.* at 3.

[78] Park et al., *supra* note 13, at 736, 738.

relatively unconcerned view on deflation, describing it as benign or even potentially positive.[79]

A number of economists began to draw greater attention to Japan's deflation, reframing it as a problem and offering diagnoses and policy recommendations. Paul Krugman, Kathryn Dominquez, and Kenneth Rogoff, for instance, viewed Japan as stuck in a liquidity trap, where deflation made traditional monetary policy ineffective since even at a zero percent interest rate monetary policy would be contractionary.[80] They called for Japan to set a very aggressive inflation target—4 percent, twice the common norm in many countries of 2 percent—to increase inflation expectations and help Japan overcome deflation.[81] Ben Bernanke concurred that deflation had caused Japan to fall into a liquidity trap and that this was dragging down Japan's economy.[82] Furthermore, he argued that monetary policy could and should be used to help address this problem.[83] Bernanke suggested that the BOJ set quantitative targets for the monetary base expansion rather than targeting the interest rate, in other words, quantitative easing (QE).[84] Some Japanese economists shared this view. Notably, Ueda Kazuo, an economist from the University of Tokyo serving on the Policy Board, suggested in 1998 that the BOJ consider setting a quantitative target.[85] The policy, though, had little support and in fact faced active opposition in the Policy Board.[86]

Over time, politics and elections accelerated the process of identifying deflation as a source of Japan's economic stagnation. The friction between the BOJ and the government emerged shortly after it achieved independence in 1998.[87] As Japan faced its banking crisis, the BOJ responded by introducing a zero-interest rate policy, largely to ease the liquidity crisis.[88] Deflation did not play much of a role in consideration

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79 *Id.* at 138.

80 Paul R. Krugman et al., *It's Baaack: Japan's Slump and the Return of the Liquidity Trap*, BROOKINGS PAPERS ON ECON. ACTIVITY, 137, 138 (1998).

81 Park et al., *supra* note 18, at 140.

82 Ben S. Bernanke, *Governor of the Federal Reserve Board, speech for Allied Science Associations Meeting: Japanese Monetary Policy: A Case of Self-Induced Paralysis?* (January 9, 2000).

83 *Id.* at 149-166.

84 *Id.*

85 *Monetary Policy, Minutes of the Monetary Policy Meeting,* BANK OF JAPAN, (Apr. 9, 1998), https://www.boj.or.jp/en/mopo/mpmsche_minu/minu_1998/g980409.htm [https://perma.cc/N22U-FPTH].

86 *Id.*

87 Dwyer, *supra* note 21, at 259-260.

88 Park et al., *supra* note 18, at 136.

of the policy.[89] The BOJ then ended its monetary policy easing after about eighteen months, despite government entreaties not to do so and to postpone the decision.[90] The BOJ, however, rejected the government's request that the Policy Board postpone its decision.[91]

The political backlash to the move was fierce and amplified by its timing, just as the United States' technology bubble was collapsing and Japan's economy fell back into recession.[92] In response, one of the ruling LDP's committees pressured the BOJ governor to step down toward the end of 2000, showing little regard for the principle of CBI.[93] Then, early in the new year, LDP politicians discussed the nuclear option of revising the new BOJ Law.[94]

As criticism of the BOJ grew, it came under strong pressure to reverse course from its earlier lifting of the zero-interest rate policy.[95] In response, the BOJ became the first central bank to employ QE.[96] Although the BOJ had rejected the policy several years before, as the political context shifted, the BOJ shifted its position in 2001. The BOJ embraced QE since returning to the former zero-interest rate policy would be perceived as an admission of its mistake in lifting it prematurely.[97]

The BOJ kept QE and other easing measures in place for a much longer time. The BOJ did not lift QE until March of 2006 when the Board concluded that deflation was in the rearview mirror.[98] The decision to wind down QE, however, was controversial. In 2005, the BOJ began to taper the size of QE.[99] Prime Minister Koizumi Junichiro and his finance

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89 *Id.*

90 Niklas Westelius, *Twenty Years of Unconventional Monetary Policies: Lessons and Way Forward for the Bank of Japan* 7 (Int'l Monetary Fund, Working Paper No. 20/226, 2020).

91 Park et al., *supra* note 18, at 139.

92 *Id.* at 144.

93 Central Banking Staff, *Japan LDP members call for BOJ's Hayami to Resign,* CENTRAL BANKING (last visited Nov. 12, 2024), https://www.centralbanking.com/central-banking/news/1409578/japan-ldp-boj-hayami-resign [https://perma.cc/LQW3-W7ZP].

94 *Monetary Policy, Minutes of the Monetary Policy Meeting,* BANK OF JAPAN, (Mar. 19, 2001), https://www.boj.or.jp/en/mopo/mpmsche_minu/minu_2001/g010319.htm [https://perma.cc/2G6M-7SG9].

95 David Bowman & Brian Doyle, *Effects of the Bank on Japan's Communication Strategy at the Zero Lower Bound*, FED. OPEN MKT. COMM. (Dec. 12, 2008), https://www.federalreserve.gov/monetarypolicy/files/fomc20081212memo22.pdf [https://perma.cc/X79K-SHED].

96 Masaaki Shirakawa, *Tumultuous Times: Central Banking in an Era of Crisis* at 98 (Yale Univ. Press 2021).

97 Park et al., *supra* note 18, at 144.

98 Bowman & Doyle, *supra* note 95.

99 *Id.*

minister opposed this policy.[100] A powerful committee of the ruling party conveyed that the government may need to consider revising the BOJ Law again.[101] As the BOJ moved to end QE, Minister Takenaka Heizo, who had been the architect of revitalizing the banking sector, and Chief Cabinet Secretary Abe Shinzo, who later became prime minister, expressed their opposition as well.[102] These reflationists argued that the data did not fully support the conclusion that deflation was over.[103] The government preferred to use the GDP deflator, which suggested that prices were still declining.[104] The Policy Board, by contrast, preferred to use core Consumer Price Index.[105] At the time that measure showed 0.6 percent year on year inflation, which was positive, but still considered quite low.[106] The controversy, however, did not stop there, since the measure was due for a periodic revision.[107] Later, when revised, the core Consumer Price Index had only increased 0.1 percent, something not lost on the reflationists.[108]

At onset of the GFC, Japan seemed relatively insulated from the GFC.[109] The BOJ focused on providing liquidity to the financial sector but took a cautious approach toward interest rates. The BOJ lowered interest rates, which had been raised twice after ending QE, slowly.[110] With the collapse of the Lehman Brothers, spreading financial crisis and plummeting global demand, the BOJ came under heavy pressure to provide more stimulus.[111] This time the Democratic Party of Japan (DPJ) emerged as the most vocal critic. After coming to power in the summer of

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[100] Komine Takao, *How Did Koizumi Cabinet Change Japan? Assessment of Koizumi's Economic Policies & Preview of Abe's Economic Stewardship,* 26 JAPAN SPOTLIGHT 6, 8 (2007).

[101] *BOJ Feeling Political Heat on Easing*, NIKKEI WEEKLY, Nov. 21, 2005, [https://perma.cc/5YFH-RXGR].

[102] Peter Alford, *Easy Does it on Monetary Policy, Japan's Bank Boss Told*, THE AUSTRALIAN, Feb. 15, 2006.

[103] *Koizumi Noncommittal about Possible BOJ Policy Change*, JAPAN ECON. NEWSWIRE, July 4, 2006.

[104] David Pilling, *Bickering Kicks Off Debate about Post-Deflation Japan Despite Ministerial Infighting and Attacks on the Central Bank, An Agreement Over Economic Direction is Taking Shape,* FIN. TIMES (LONDON, ENG.), Jan. 13, 2006.

[105] Japan's definition of core inflation is defined slightly different than in other countries. It excludes only fresh food. The OECD definition includes food and energy.

[106] *ASIA-PACIFIC: Japan Puts Up Growth Forecast to 1.5 Percent*, FIN. TIMES (LONDON, ENG.), Oct. 20, 2000.

[107] Park et al., *supra* note 18, at 150.

[108] *Id.*

[109] *Id*. at 154.

[110] *Id.* at 151–56.

[111] *Id*. at 154.

2009 for the first time since its establishment, party members formed the "Anti-Deflation League," which rapidly grew to include about 150 members.[112] The League published a series of proposals that included changing the BOJ Law to include an inflation target over 2 percent, establishing an employment mandate, and reforming the selection of Policy Board members.[113] The Anti-Deflation League also called, essentially, for QE, by having the BOJ expand its balance sheet through purchases of Japanese government bonds.[114] Other smaller parties piled on the criticism and announced their own proposals for limiting legal independence, adding inflation targets and increasing BOJ asset purchases.[115]

With the GFC unfolding, the new DPJ government announced that Japan was falling back into deflation and called for more aggressive measures.[116] Despite the pressure, the BOJ remained reluctant to increase the size of its QE asset purchases, and the governor of the BOJ continued to argue that monetary policy was not contributing to deflation.[117] Finally, the BOJ relented, increasing the size of its asset purchases in the fall of 2010, but the new policy was deemed insufficient by the government, and the pressure was far from fading.[118]

In the wake of the Great East Japan Earthquake and the destructive tsunami that it unleashed, the economy suffered another shock.[119] Some within the DPJ called for the issuance of government reconstruction bonds that could directly be purchased by the BOJ, but the BOJ immediately rejected the proposal.[120] The BOJ, however, did agree in early 2012 to an inflation "goal," rather than a target, of 1 percent.[121] Then the State Minister of Economic and Fiscal Policy, Seiji Maehara, tried to convince the BOJ to sign an accord with the government that stated a commitment

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112 Dwyer, *supra* note 21, at 189.
113 *Id.*
114 *Id.* at 189–90.
115 *Id.*
116 *Id.*
117 Park, *supra* note 30, at 443.
118 Kazuo Ueda, *Response of Asset Prices to Monetary Policy Under Abenomics*, 8 ASIAN ECON. POL'Y REV., Dec. 20, 2013, at 252.
119 Norio O. et al., *The 2011 Eastern Japan Great Earthquake Disaster: Overview and Comments*, 2 INT'L J. OF DISASTER RISK SCI., Aug. 8, 2012, at 34.
120 Park et al., *supra* note 18, at 159.
121 *FOCUS: Japan Politicians Seek to Amend BOJ Law*, JIJI PRESS TICKER SERVICE, May 7, 2012.

to achieve the 1 percent inflation goal, while in the end it was unsuccessful.[122]

The politicization of monetary policy only accelerated. In the run-up to the next general election in December 2012, which would determine the prime minister and cabinet, both parties bashed the BOJ and called for prioritizing overcoming deflation in order to restore economic vitality.[123] The DPJ argued for ending deflation and achieving 1 percent inflation, and included both as policy goals in its official party manifesto.[124] Not to be outdone, the LDP listed overcoming deflation as one of its top priorities, calling for a 2 percent inflation target, the use of stimulative monetary policy to achieve this goal, and consideration of revising the BOJ Law.[125] The head of the party, Shinzo Abe, had long expressed frustration with the BOJ and called for large-scale purchases of governments bonds.[126] Brazenly, Shirakawa Masaaki, the governor of the BOJ, publicly opposed the monetary policy elements of the manifesto expressed by Abe and the LDP.[127] In the end, the LDP won the election in a landslide, securing a mandate for its monetary policy. To achieve its stated goals, the LDP exerted pressure on the BOJ and appointed new members of the BOJ Policy Board, as the next section discusses.[128]

A. LDP Dominance and Control Over the Policy Board

Before the Abe Administration, the list of nominees for BOJ Board members was coordinated by the MOF and the BOJ.[129] Following the LDP's landslide victory, the Abe Administration altered the long-

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[122] *Id.*

[123] Ben McLannahan, *BOJ Holds Firm Amid Political Pressure*, FIN. TIMES (LONDON, ENG.), (Nov. 20, 2012), https://www.ft.com/content/8e09106e-32c4-11e2-916a-00144feabdc0 [https://perma.cc/GQ9F-6J8S].

[124] Park et al., *supra* note 18, at 159.

[125] Tetsushi Kajimoto, *Japan's Incoming PM Keeps Up Pressure on BOJ to Attack Deflation*, CHICAGO TRIB. (Dec. 28, 2012), https://www.chicagotribune.com/2012/12/24/japans-incoming-pm-keeps-up-pressure-on-boj-to-attack-deflation-2/ [https://perma.cc/D2N6-ZB63].

[126] Denise Roland, *Debt Crisis: as it happened*, TELEGRAPH (Dec. 20, 2012), https://www.telegraph.co.uk/finance/debt-crisis-live/9756554/Debt-Crisis-as-it-happened-December-20-2012.html ("Bank of Japan launches 10 trillion yen of fresh easing; The Bank of Japan has ramped-up its money printing program by 10 trillion yen (£732m), days after the conservative Liberal Democratic Party won an election promising to boost spending and pressure the central bank for aggressive action.") [https://perma.cc/7ZB4-PXAP].

[127] JIN KUJIRAOKA, THE BANK OF JAPAN AND POLITICS: 20 YEARS OF SECRET STRUGGLE (2017).

[128] Kensuke Karube, *Japanese Economic Policy and Politics*, 8 JAPAN SPOTLIGHT, 32 (Jan./Feb. 2017).

[129] Park et al., *supra* note 18, at 159.

standing bureaucratic-driven appointment process and asserted firm political control. This article argues that the mechanisms established under the Bank of Japan Act were designed to limit interference from government. In the face of direct political pressure, legal independence had little effect in limiting political influence under the Abe Administration.

Historically, before the Bank of Japan Law in 1998, the appointment of the BOJ governor was heavily influenced by the MOF and the BOJ, a practice known as "*Tasaki gake*" (MOF-BOJ alternation).[130] This practice ensured that the roles of BOJ governor and deputy governor were split between career officials from the MOF and the BOJ, maintaining both institutions' influence over monetary policy.[131] After the new law was implemented, only BOJ officials—Hayami, Fukui, and Shirakawa—were appointed as a governor.[132] The only Ministry of Finance official appointed after the Bank of Japan Law was Toshiro Muto, who served as Administrative Vice-Minister, the highest-ranking career official at the MOF.[133] However, he could not be promoted to governor in 2008 due to opposition from the DPJ.[134] Since then, the influence of both the MOF and the BOJ has gradually diminished.

The political influence increased after the LDP victory in the December 2012 general election. Prime Minister Abe sought to directly influence BOJ policies by replacing the governor and deputy governors, whose terms were set to expire in April the following year.[135] At that time, two board members were considered to be supportive of the direction of monetary easing.[136] If the new governor and deputy governors shared these views, it could result in a shift in the BOJ's monetary policy direction. Abe explicitly stated, regarding the selection of the BOJ

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[130] *Id.* at 71.

[131] *See id.*; *List of Governors*, BANK OF JAPAN, HTTPS://WWW.BOJ.OR.JP/EN/ABOUT/OUTLINE/HISTORY/PRE_GOV/INDEX.HTM (last visited Nov. 1, 2024) [https://perma.cc/44YA-ZNJ3].

[132] *List of Governors*, *supra* note 131.

[133] *Nominee Chosen for Chief's Post at Bank of Japan*, N.Y. TIMES (Mar. 8, 2008), https://www.nytimes.com/2008/03/08/business/worldbusiness/08yen.html?smid=url-share [https://perma.cc/G8F7-ZM9Z].

[134] *Succession Crisis for the Bank of Japan*, FORBES (Mar. 12, 2008, 1:52AM), https://www.forbes.com/2008/03/12/japan-boj-muto-markets-econ-cx_jc_0312markets1.html [https://perma.cc/E72H-NUGA].

[135] KENSUKE KARUBE, JINJI TO KENRYOKU: NICHIGIN SŌSAI POSUTO TO CHŪŌ GINKŌ NO DOKURITSU [Jinji to Kenryoku: The Post of Governor of the Bank of Japan and the Independence of Central Banks] (2024) (Japan).

[136] *Id.*

governor and deputy governors, "I would like to see someone who agrees with the inflation target."[137] He made it clear that agreement with the 2 percent inflation target, a key element of the LDP's manifesto, was a prerequisite for appointment.[138]

When Abe considered the nomination for BOJ governor, scholars and economists were prominently mentioned as potential candidates. Among those discussed were Professor Takatoshi Ito of the University of Tokyo, who supported adopting an inflation target, and Kazumasa Iwata, President of the Japan Center for Economic Research, who proposed a government-BOJ fund to purchase foreign bonds.[139] However, Abe nominated Haruhiko Kuroda as the new governor.[140] Although Kuroda had a long career at the MOF, his background was atypical compared to previous MOF officials who had served as BOJ governors. He was seen as an outlier, being a proponent of inflation targeting and having extensive experience with international financial institutions such as the Asian Development Bank.[141] Abe also nominated Kikuo Iwata as one of Deputy Governors, a professor at Gakushuin University, who had significantly influenced Abe's views on reflationary policy and was regarded as a leading figure among those advocating for large-scale QE.[142]

At the first meeting under Kuroda's leadership, the BOJ introduced Quantitative and Qualitative Monetary Easing.[143] The Kuroda-led BOJ aimed to double the monetary base over two years and set a target of achieving a 2 percent inflation rate within that period.[144] This "2-2-2" policy involved aggressive asset purchases, including Japanese government bonds, to lower interest rates and stimulate spending and investment.[145] Although one board member dissented, this policy action

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[137] *Japan's Abe heaps pressure on BOJ to set 2 percent inflation target*, REUTERS (Dec. 22, 2012, 5:37 PM), https://www.reuters.com/article/business/japans-abe-heaps-pressure-on-boj-to-set-2-percent-inflation-target-idUSBRE8BM00C/ [https://perma.cc/6WXG-R9SD].

[138] *Id.*

[139] KARUBE, *supra* note 135.

[140] *Id.*

[141] *Id.*

[142] *Id.*

[143] BANK OF JAPAN, INTRODUCTION OF THE "QUANTITATIVE AND QUALITATIVE MONETARY EASING" (2013), https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2013/k130404a.pdf [perma.cc/ADM3-76QL].

[144] *Id.* at 1.

[145] *Id.*

was well-received by the markets and became known as the first arrow of "Abenomics," Abe's broader economic strategy.[146]

To further consolidate influence over the BOJ Policy Board, the Abe Administration nominated individuals who strongly supported aggressive monetary easing. Policy Board members were selected from a limited pool of candidates, mainly comprising academic scholars, market economists, and representatives from the banking and industrial sectors.[147] Similar to the process of appointing governors, the initial list of nominees was traditionally created by the MOF in collaboration with the BOJ.[148] However, the Abe Administration created the list from the beginning to the end.[149] Abe consulted with Deputy Governor Iwata to compile the nominees, specifically targeting professors from universities and market economists, replacing individuals who were not in favor of expansive monetary policies.[150] For instance, Yasushi Harada, who had a close relationship with Deputy Governor Iwata and collaborated with him to organize the study group on reflationary policy, was the first one to be selected.[151]

There are some exceptions. Despite Abe's strong leadership, he was unable to eliminate the positions reserved for representatives from the banking and industrial sectors. For these sectors, the Cabinet Office sought nominees from the Japan Business Federation (*Keidanren* in Japanese), an interest group representing large firms, due to its close ties with the LDP.[152] However, as shown in Figure 4, by appointing three allies—Harada, Sakurai, and Kataoka—Abe secured five favorable votes for his administration on the Policy Board. This dominance persisted into Governor Kuroda's second term.

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146 アベノミクス成長戦略～これまでの更新情報～[Abenomics Growth Strategy: Updates to Date], PRIME MINISTER'S OFF. OF JAPAN (Jul. 17, 2020), https://www.kantei.go.jp/jp/headline/seicho_senryaku2013_old.html [perma.cc/A2JF-779F].

147 KENESUKE KARUBE, 人事と権力 日銀総裁ポストと中央銀行の独立 [PERSONNEL AND POWER - THE POST OF GOVERNOR OF THE BANK OF JAPAN AND THE INDEPENDENCE OF CENTRAL BANKS] (2024).

148 *Id.*

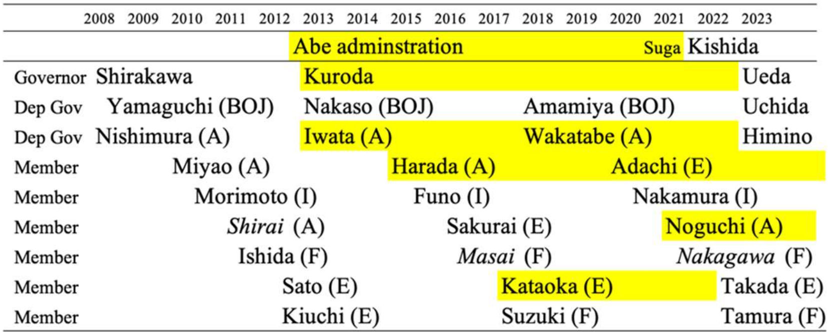
149 *Id.*

150 *Id.*

151 *Id.*

152 *Id.*

Figure 4
Members of the BOJ Policy Board



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Why did appointing a committee enable changes in policy direction? This article argues that the Bank of Japan Law was insufficient to ensure the autonomy of the Policy Boar since the government was able to leverage the appointment process and critically a popular mandate to exert control. The intent of the law and the selection of independent members was intended to enhance the autonomy of the Policy Board, but *de facto*, these two mechanisms could not prevent the politicization of monetary policy.

First, while board members are nominated by the Cabinet, their appointments require approval from both chambers of the Diet.[154] This executive constraint works when the government and the Diet were politically divided; even without a complete split, opposition parties could influence the Cabinet through Diet discussions. In 2008, when Governor Fukui's term ended, the DPJ, the largest opposition party at the time, successfully opposed the nomination of Toshiro Muto for BOJ governor in the Upper House.[155] While this demonstrated a functioning system of checks and balances, the opposition party faced criticism for creating a temporary vacancy in the BOJ governor position.[156] However, in 2012,

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[153] *Policy Board*, BANK OF JAPAN, https://www.boj.or.jp/en/about/organization/policyboard/index.htm (last visited Nov. 14, 2024) [perma.cc/UZ9J-JR2P]. Yellow shades indicate those who supported Abe's policy direction. Alphabet indicates previous career: A-Academica, E-Market economist. F- Financial institution, I- Industry. *Italic* indicates female member.

[154] Bank of Japan Law of 1942, *supra* note 43.

[155] KARUBE, *supra* note 135.

[156] *See e.g., 169th Diet Plenary Session No. 9,* HOUSE OF REP. JAPAN (Mar. 13, 2008), https://www.shugiin.go.jp/internet/itdb_kaigirokua.nsf/html/kaigirokua/000116920080313009.htm [perma.cc/VUV8-FR6T].

when Haruhiko Kuroda was nominated, the DPJ lacked the political will to strongly oppose the nominations, despite being the largest party in the Upper House while the LDP and its coalition partner did not hold a majority in the House.[157] Thus, the initial nominations were swiftly approved: While the DPJ voted in large numbers against Deputy Governor Iwata's nomination (124–96),[158] they supported Governor Kuroda (186–34)[159] and Deputy Governor Nakaso (199–22).[160] According to Karube, the DPJ lacked political capital for several reasons: they were still in shock from their loss in the general election, they did not hold a majority and the LDP could have formed a coalition with other opposition parties, and they were haunted by the criticism they faced or previously creating a vacant BOJ governor seat.[161] As a result, the Diet provided little constraint to the executive.

Second, although board members are expected to be independent and provide diverse opinions, they followed the leadership of the new Abe-Kuroda regime, lacking any significant deterrent power. Article 23.2 of the Bank of Japan Law specifies that board members should be "among persons with relevant expertise, including experts on the economy or finance."[162] During the legislative discussions, officials from both the BOJ and the MOF, along with the committee members involved in drafting the law, anticipated that the Board would reflect a range of views on monetary policy.[163] Indeed, the first Board under Governor Hayami demonstrated this diversity, with members expressing dissent in both directions of the policy rates.[164] However, when Kuroda's leadership began, all but one board member supported the new policies without dissent.[165] The only exception was former market economist Takahide Kiuchi, who opposed the Qualitative Monetary Easing policy.[166] As a result, the *de jure*

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157 KARUBE, *supra* note 135.

158 *183rd National Diet Voting Results*, HOUSE OF COUNCILLORS, THE NAT'L DIET OF JAPAN (Mar. 15, 2023), https://www.sangiin.go.jp/japanese/touhyoulist/183/183-0315-v002.htm [https://perma.cc/8A6K-SM5M].

159 *Id.*

160 *Id.*

161 KARUBE, *supra* note 135.

162 Bank of Japan Law of 1942, *supra* note 43.

163 Dwyer, *supra* note 21, at 245-62.

164 *See Minutes of the Monetary Policy Meeting,* BANK OF JAPAN (1999), https://www.boj.or.jp/en/mopo/mpmsche_minu/minu_1999/index.htm [https://perma.cc/7EYK-BCVF].

165 BANK OF JAPAN, *supra* note 143.

166 *Id.*

independence of the board members did not function as intended given the Abe administration's influence over the BOJ.[167]

B. STRUCTURAL POLITICIZATION THROUGH THE CENTRAL BANK'S BALANCE SHEET

This article argues that monetary easing policies that expand the central bank's balance sheet structurally politicizes future central bank policy, and thus lower the *de facto* independence of the BOJ. Due to the long-lasting deflationary economy, the BOJ implemented a variety of balance sheet policies as a pioneer among other central bank peers.[168] One consequence is that when a central bank holds a large amount of government bonds, it blurs the boundary between government fiscal policy and the central bank's monetary policy, as fiscal and monetary policies become increasingly intertwined. Another issue is that there is a risk that a central bank's holding of equities will be politicized. The BOJ has held a large number of equities, which, unlike bonds, do not have a maturity date.[169] Thus, the sale of the equity portion of its balance sheet can become extremely difficult and politically charged. Furthermore, since this would directly intervene in the allocation of resources in the private sector, it would go beyond the neutrality that is traditionally associated with interest rate policy and thus the central bank would face new types of decisions with distributional implications. In this respect, there is a risk that future balance sheet policies could become politicized as well.

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167 Park, *supra* note 30.

168 *See* MONETARY AFF.'S DEP'T, BANK OF JAPAN, CENTRAL BANK FINANCES AND MONETARY POLICY CONDUCT (2023).

169 *Id*.

Figure 5
Balance Sheet Policy Across Major Central Banks

	BOJ	FRB	ECB	BOE
Government bonds	○	○	○	○
MBSs Covered bonds	×	○ Jan. 2009	○ July 2009	×
Other ABSs	○ Aug. 2003	○ Sept. 2008	○ Nov. 2014	○ Nov. 2010
Municipal bonds	×	○ June 2020	○ Dec. 2015	×
CP	○ Jan. 2009	○ Oct. 2008	○ June 2016	○ Feb. 2009
Corporate bonds	○ Mar. 2009	○ June 2020	○ June 2016	○ Mar. 2009
Stock index-linked ETFs REITs	○ Dec. 2010	×	×	×

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One measurement of CBI is whether the central bank law prohibits the direct purchase of government bonds from the government.[171] Typically, a central bank's role is to maintain price stability and ensure the stability of the financial system, with its independence believed to enhance both its credibility and effectiveness.[172] However, if the government expands its fiscal deficit and the central bank purchases large quantities of government bonds to support the government's fiscal position, the boundary between fiscal and monetary policy becomes blurred. This situation, known as monetization, could undermine the central bank's independence, as it risks subordinating monetary policy to the government's fiscal policy.[173]

In the 2000s, the BOJ, along with other central banks after the GFC, purchased government bonds through the markets to avoid being perceived as engaging in monetization. However, much like other central banks, the interdependence between monetary and fiscal policies deepened after the COVID-19 pandemic. Despite implementing the "2-2-2" policy, the Kuroda-led BOJ was unable to achieve the 2 percent

170 *Id.* at 34.
171 *See* Cukierman et al., *supra* note 5.
172 *Id.* at 354.
173 *See generally* FREDERIC MISHKIN, THE ECONOMICS OF MONEY, BANKING AND FINANCIAL MARKETS (11th ed. 2016).

inflation target within two years.[174] Consequently, the BOJ introduced a series of unconventional measures, such as additional government bond purchases,[175] negative interest rates,[176] and yield curve control.[177] By the time of the COVID-19 pandemic, the BOJ had already exhausted most of its monetary policy tools to stimulate the economy.

Meanwhile, despite Japan's prolonged primary balance deficit and significantly high level of public debt, the low interest rates on government bonds—sustained by the BOJ—lowered the cost of fiscal expansion.[178] Fiscal stimulus became the primary measure to address the economic fallout from the COVID-19 pandemic.[179] This, however, led to a deepening of the monetary-fiscal nexus. In fact, as Figure 6 shows, the BOJ's holdings of Japanese government bonds are correlated with the rising government debt relative to GDP. While the BOJ began to decrease the amount of the government bonds holdings in 2024,[180] it will take a prolonged time to normalize its balances sheet.[181]

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[174] Takuji Kawamoto & Moe Nakahama, *Why Did the BOJ Not Achieve the 2 Percent Inflation Target with a Time Horizon of About Two Years?* 1-23 (Bank of Japan, Working Paper No.17-E-10, 2017).

[175] BANK OF JAPAN, EXPANSION OF THE QUANTITATIVE AND QUALITATIVE MONETARY EASING (2014), https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2014/k141031a.pdf [https://perma.cc/8MSV-QP2L].

[176] BANK OF JAPAN, INTRODUCTION OF "QUANTITATIVE AND QUALITATIVE MONETARY EASING WITH A NEGATIVE INTEREST RATE" (2016), https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2016/k160129a.pdf [https://perma.cc/TNC6-KTF2].

[177] BANK OF JAPAN, NEW FRAMEWORK FOR STRENGTHENING MONETARY EASING: "QUANTITATIVE AND QUALITATIVE MONETARY EASING WITH YIELD CURVE CONTROL" (2016), https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2016/k160921a.pdf [https://perma.cc/Y38B-FMNX].

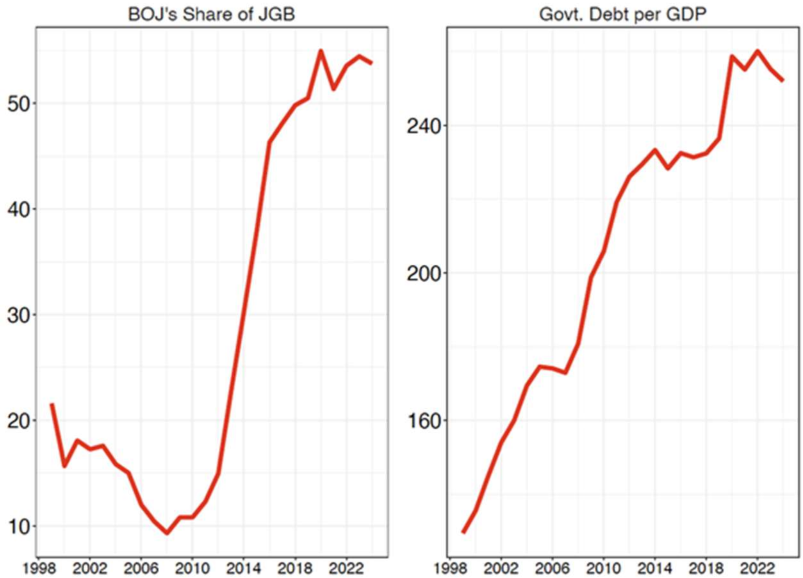
[178] Kenya Amano & Saori N. Katada, *Economic Policy Trilemma: Macroeconomic Politics in the 2021 Election, in* JAPAN DECIDES 2021: THE JAPANESE GENERAL ELECTION 255, 256 (Robert Pekkanen, Steven Reed & Daniel Smith eds., Palgrave Macmillan 2023).

[179] *Id.*

[180] BANK OF JAPAN, CHANGE IN THE GUIDELINE FOR MONEY MARKET OPERATIONS AND DECISION ON THE PLAN FOR THE REDUCTION OF THE PURCHASE AMOUNT OF JAPANESE GOVERNMENT BONDS (2014), https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2024/k240731a.pdf [https://perma.cc/MJL5-AHJT].

[181] Peter Karadi & Anton Nakov, *Effectiveness and Addictiveness of Quantitative Easing*, 117 J. Monetary Econ. 1096, 1096 (2021).

Figure 6
BOJ's Japanese Government Bonds Holdings and Government Debt



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The BOJ's practice of buying equities through exchange-traded funds (ETFs) could have already involved distributional issues and it could lead to future politicization when the BOJ sells the ETFs. While the ETF purchases by the BOJ raise stock prices,[183] and reduce equity risk premium,[184] the BOJ could distort the price discovery function and resource distribution. This is why, to our best knowledge, the BOJ is the only central bank that purchases equities to achieve their monetary policy goals. Legally, the Bank of Japan Law does not explicitly permit the BOJ

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[182] *BOJ Time-Series Data Search*, BANK OF JAPAN, https://www.stat-search.boj.or.jp/index_en.html (last visited Nov. 14, 2024) [https://perma.cc/9DNN-9SJQ]; *World Economic Outlook Database,* INT'L MONETARY FUND (Oct. 2023), https://www.imf.org/en/Publications/WEO/weo-database/2023/October/ [https://perma.cc/2HTM-8M3K].

[183] Ben Charoenwong, Randall Morck & Yupana Wiwattanakantag, *Bank of Japan Equity Purchases: The (Non-)Effects of Extreme Quantitative Easing*, 25 REV. FIN. 713, 718 (2021); Kimie Harada & Tatsuyoshi Okimoto, *The BOJ's ETF Purchases and Its Effects on Nikkei 225 Stocks*, 77 INT'L REV. FIN. ANALYSIS 1, 5 (2021).

[184] Ko Adachi, Kazuo Hiraki & Takashi Kitamura, *The Effects of the Bank of Japan's ETF Purchases on Risk Premia in the Stock Markets* 2 (Bank of Japan, Working Paper No. 21-E-3, 2021); Mitsuhiro Katagiri et al., *Bank of Japan's ETF Purchase Program and Equity Risk Premium: A CAPM Interpretation* 1, 4 (Bank Int'l Settlements, Working Paper No. 1029, 2022).

to purchase equities, but the government and the BOJ use the loophole of the law to enable the bank to obtain equity assets.

The BOJ first conducted purchases of equities held by financial institutions from 2002 to 2004 responding to the Non-Performing Loan issue, and from 2009 to 2010 during the GFC.[185] The BOJ believed that these actions were indispensable for ensuring the stability of the financial system. To legally enable this policy action, the government and the BOJ used the exception clause of Article 43 in the Bank of Japan Law.[186] Article 43 prohibits the BOJ from operating other businesses not defined in the Bank of Japan Law.[187] However, Article 43 also includes the exception clause that allows the BOJ to conduct the relevant business if it is necessary to achieve the Bank's purpose specified by the Law and the Bank has obtained authorization from the Minister of Finance and the Prime Minister.[188] When the BOJ began a more aggressive equity purchase program through ETFs in 2010 under Governor Shirakawa,[189] and later under Governor Kuroda in 2013,[190] the exception clause of Article 43 was used without any legislative changes.[191]

The risks associated with the BOJ's ETF purchases include market distortion and altered corporate governance. Continuous intervention in equity markets can disrupt price discovery, leading to risk mispricing. Markets may also become overly reliant on central bank support, causing instability when the BOJ unwinds its positions, which could be a lengthy process.[192] As shown in Figure 7, while the BOJ bought more than two thousand equities, its purchases were concentrated in a few companies. This concentration could inadvertently affect corporate governance, especially if the BOJ becomes a major shareholder. For example, BOJ's

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185 *Stock Purchase*, BANK OF JAPAN, https://www.boj.or.jp/finsys/spp/index.htm (last visited Nov. 14, 2024) [https://perma.cc/7TXR-HW4P].

186 *See Stock Purchase Guidelines,* BANK OF JAPAN (Oct. 11, 2002), https://www.boj.or.jp/en/finsys/spp/fss0210b.htm [https://perma.cc/ZK88-PP6T].

187 Bank of Japan Act, Law No. 89 of 1997, art. 43 (Japan).

188 *Id*.

189 BANK OF JAPAN, *Statement on Monetary Policy* (Oct. 28, 2010), https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2013/k130404a.pdf [https://perma.cc/NVC4-7AFB].

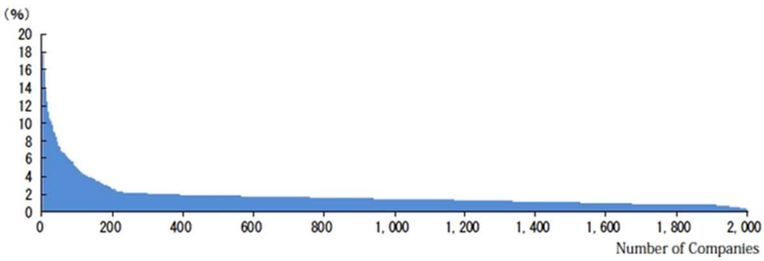
190 BANK OF JAPAN, *supra* note 143.

191 BANK OF JAPAN, *Establishment and Abolishment of Principal Terms and Conditions in accordance with the Introduction of the "Quantitative and Qualitative Monetary Easing* (2013), https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2013/rel130404a.pdf [https://perma.cc/6WHU-VPVD].

192 KENZŌ YAMAMOTO, 異次元緩和の罪と罰 [CRIME AND PUNISHMENT OF EXTRADIMENSIONAL RELAXATION] (2024).

stake in Advantest grew from 6 percent in 2014 to over 25 percent in ten years. Though the ETF purchase program ended in 2024,[193] the BOJ's passive influence on corporate governance and resource allocation through equity markets may harm its credibility. Therefore, the program, initiated without full adherence to the *de jure* Bank of Japan Law, could also undermine the BOJ's *de facto* independence.

Figure 7
BOJ Share Holdings Ratio as of September 2017



[194]

Figure 8
The Estimates of BOJ's Share Holdings for Individual Companies

	March, 2023		March, 2018		March, 2014	
	BOJ Share (%)	BOJ Holdings bil. Yen	BOJ Share (%)	BOJ Holdings bil. Yen	BOJ Share (%)	BOJ Holdings bil. Yen
1 Advantest	25.6	596.8	19.2	88.1	5.9	13.1
2 TDK	20.4	374.2	15.8	199.7	4.7	26.4
3 Fast Retailing	20.2	1,853.2	17.4	801.8	5.4	214.9
4 Taiyo Yuden	19.8	114.5	16.6	36.4	5	7.6
5 Toho Zinc	19.5	5.4	15.1	10.4	4.5	1.9
6 Nitto Denko	19.4	248.0	12.6	173.1	3.7	31.7
7 Trend Micro	19.2	174.8	14.4	127.0	4.2	19.0
8 Tokyo Electron Limited	18.2	1,377.8	12.9	429.9	3.6	40.7
9 Comsys	18.2	62.6	14	55.0	4.1	9.8
10 Nissan Chemical	18.1	153.5	13.9	92.5	3.9	9.7

[195]

193 *See* BANK OF JAPAN, CHANGES IN THE MONETARY POLICY FRAMEWORK (2024), https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2024/k240319a.pdf [https://perma.cc/4EAV-MF8F].

194 *See* JAPAN RSCH. INST., 日銀の ETF 買入政策の功罪 /THE PROS AND CONS OF THE BOJ'S ETF PURCHASE POLICY] (Mar. 30, 2018), https://www.jri.co.jp/MediaLibrary/file/report/researchfocus/pdf/10382.pdf [https://perma.cc/WW7D-8ZME].

195 *See generally 「日銀が大株主」の企業ランキング【上位 100 社・完全版】年 535 億円もの国民財産流出の大問題* [Ranking of Companies Where "The Bank of Japan is a Major

III. CONCLUSION

This Article elucidates two mechanisms that can produce a substantial loss of *de facto* independence for a central bank. First, when politicians faced an intransigent BOJ and largely exhausted the traditional channels of applying pressure, the government resorted to the electoral process to win a clear mandate for its monetary policy, and then used the appointments of the Policy Board members to push through a major shift in monetary policy. The success of this policy required political stability. With Prime Minister Abe in power from 2012 to 2020 and the LDP remaining in power after his departure, the government has been able to keep tight control over the BOJ. Another key factor was relatively low inflation rates, at least until the pandemic. The political takeover of the BOJ and the extensive monetary easing did not lead to a large increase in inflation, thus there was not any need to take away the punchbowl, despite the vast asset purchases and aggressive monetary easing since 2013. One consequence of this policy, though, is that it has led the BOJ to be in a more politicized structural position, a position in which it is now deeply embedded in public finance as it is essentially the largest funder of the government. Similarly, the BOJ now holds a critical position in private equity markets. Thus, monetary policy now has greater and wider ripple effects throughout the economy, factors that the BOJ will now have to consider more carefully and that politicians, too, will follow closely.

Given the recent political history, it is unlikely that politicians in Japan will cede much agency slack to the BOJ, thus, in effect, rewriting the norms around government–BOJ relations. There are, however, two caveats. First, while prices are currently moderating, a sharp rise in inflation would create strong pressure to bring prices down. The Japanese population is highly inflation averse.[196] They are used to nearly twenty-five years of very low inflation. Furthermore, there is a high share of the elderly who are particularly sensitive to inflation.[197] Thus, in the face of inflation, politicians would have stronger incentives to accept some retreat from easing to tightening. Second, while part of the logic of QE was to lower the value of the yen, a sharp collapse in the yen, which would raise

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Shareholder" [Top 100 Companies, Complete Version]. A major problem of national wealth outflow of 53.5 billion yen a year, DIAMOND ONLINE (May 3, 2023, 4:50 AM), https://diamond.jp/articles/-/322328 [https://perma.cc/TZJ8-BPFK].

[196] Park et al., *supra* note 13.

[197] Kyohei Yamada & Gene Park, *Aging and the Politics of Monetary Policy in Japan*, 23 JAP. J. POL. SCI. 333, 337-40 (2022).

prices due to higher import costs, could trigger a decline in confidence in the currency and thus might also force a political retreat and provide latitude for the BOJ to pursue tightening. Even in such a situation, however, the BOJ's position in the economy stemming from its large asset holdings will continue to shape monetary politics for many years to come.