

# The Boundaries of Central Bank Independence: Lessons from Unconventional Times

Keynote Speech by Athanasios Orphanides

*What institutional arrangements for an independent central bank with a price stability mandate promote good policy outcomes when unconventional policies become necessary? Unconventional monetary policy poses challenges. The large scale asset purchases needed to counteract the zero lower bound on nominal interest rates have uncomfortable fiscal and distributional consequences and require central banks to assume greater risks on their balance sheets. Lack of clarity on the precise definition of price stability, coupled with concerns about the legitimacy of large balance sheet expansions, hinders policy: It encourages the central bank to eschew the decisive quantitative easing needed to reflate the economy and instead to accommodate too-low inflation. The experience of the Bank of Japan's encounter with the zero lower bound suggests important benefits from a clear definition of price stability as a symmetric 2% goal for inflation, which the Bank of Japan adopted in 2013.*

Keywords: Bank of Japan; Zero lower bound; Quantitative easing; Central bank independence; Price stability; Inflation target; Balance sheet risk

JEL Classification: E52, E58, E61, N15

Professor of the Practice of Global Economics and Management at the MIT Sloan School of Management (E-mail: [athanasios.orphanides@mit.edu](mailto:athanasios.orphanides@mit.edu))

.....  
This paper was prepared for the 2018 BOJ-IMES Conference, "Central Bank in a Changing World" held by the Institute for Monetary and Economic Studies, Bank of Japan, in Tokyo, Japan, on May 30–31, 2018. The views expressed are those of the author and do not necessarily reflect the official views of the Bank of Japan.

## I. Introduction

What are the appropriate boundaries of central bank independence? By revealing the immense power of central bank balance sheets, the unconventional response to the Global Financial Crisis (GFC) has rekindled a debate on institutional arrangements. Unconventional monetary policy comes with challenges. Counteracting the zero lower bound (ZLB) on nominal interest rates with policies such as large scale asset purchases requires central banks to assume greater risks on their balance sheets. The fiscal and distributional consequences of these policies are more pronounced than conventional policy adjusting short-term interest rates. This draws unwanted attention to central banks and raises questions about their powers, their mandates, their legitimacy, and their democratic accountability—the boundaries of their independence. Unconventional times stress-test institutional arrangements.

This paper draws lessons from the experience of the Bank of Japan (BOJ) since the late 1990s for the institutional design of independent central banks. Following a global trend towards greater central bank independence, the BOJ became an independent central bank with a price stability mandate in 1998. Soon after it became independent, the BOJ encountered the challenges associated with the ZLB, challenges that had not been adequately studied in the context of central bank independence before then. The BOJ's encounter with the ZLB proved more challenging than had been anticipated, a challenge that was better appreciated by other central banks a decade later—in the aftermath of the GFC.<sup>1</sup> The Federal Reserve (FED) and the European Central Bank (ECB), for example, experienced the ZLB challenge for many years, in contrast to pre-crisis predictions that suggested such episodes would likely be short in duration.<sup>2</sup>

While comparing the balance sheet policies of the BOJ, FED and ECB since the GFC is informative for understanding some of the associated challenges, the BOJ experience with unconventional policies proves particularly useful because of two distinct episodes of quantitative easing: The Quantitative Easing (QE) policy from 2001 until 2006 and the Quantitative and Qualitative Easing (QQE) policy implemented since 2013. The BOJ experience highlights a number of issues that matter for the challenges associated with the ZLB: The formulation of the central bank mandate; the importance of a transparent definition of price stability as a precise symmetric target; the need for clarity in accounting for balance sheet risk; and the importance of internalizing the fiscal consequences of monetary policy.

One lesson from the BOJ experience that deserves particular attention relates to the role of clarity in the precise definition of price stability for an independent central bank. Lack of clarity on the precise meaning of price stability, combined with concerns regarding the legitimacy of large balance sheet expansion and assumption of the associated balance sheet risk, hampered policy in the QE episode. By contrast, a joint statement of the BOJ and the Japanese government in 2013, providing a precise definition of price stability as a symmetric 2% goal for inflation, facilitated the more decisive

1. Not for lack of warning. I recall that at a Federal Reserve conference on the ZLB, Professor Ueda, who at the time was a member of the BOJ Board, ended his remarks with the following message to his fellow central bankers: "Do not put yourself into the position of zero rates. I tell you it will be a lot more painful than you can possibly imagine" (Ueda [2000, p. 1109]).

2. See Williams (2014) and references therein.

balance sheet expansion in the QQE episode.

## II. The Challenge of Central Bank Independence

The case for central bank independence has a long history, grounded in theory and empirical experience. As with other aspects of good economic governance in democratic societies, however, the case for central bank independence is not incontestable. The appropriate boundaries for independence are not always clear. Achieving economic efficiency with delegated discretionary power while maintaining democratic legitimacy poses a challenging institutional design problem.<sup>3</sup> Depending on the legal and institutional framework, central bank independence can mean different things and have quite different implications for the degree of discretionary authority delegated to the central bank. Greater independence does not necessarily lead to better macroeconomic performance over time than less independence. Understanding practical problems and challenges is important for identifying the proper boundaries of central bank independence and promoting policy that best contributes to society's welfare.

Monetary policy is a powerful tool for shaping a nation's economy. In the hands of political authorities that tend to be more shortsighted than is ideal, this power invites misuse. The temptation to enjoy the short-term benefits of overly expansionary monetary policy is hard to resist when judged against the costs of higher inflation that only materialize later. When political authorities maintain control of monetary policy, this temptation often results in an inflationary bias. Over time, economic welfare suffers as price stability is compromised without any perceptible economic gain. Central bank independence offers a solution to this dynamic consistency problem: Monetary policy can be delegated to an independent central bank with a price stability mandate. An alternative solution is the adoption of a monetary rule: Maintaining price stability over time while providing systematic countercyclical support to the economy.

The formal theory favoring central bank independence and systematic monetary policy was advanced following the experience of the 1970s stagflation that afflicted most advanced economies.<sup>4</sup> The crux of the arguments, however, was already presented earlier. In an important short article written in 1962, Milton Friedman described the essence of why central bank independence may be desirable as follows: "The device of an independent central bank embodies the very appealing idea that it is essential to prevent monetary policy from being a day-to-day plaything at the mercy of every whim of the current political authorities" (Friedman [1968, pp. 177–178]).

While acknowledging the appeal of central bank independence, Friedman expressed a number of reservations that led him to the conclusion that, in practice, the adoption of a monetary policy rule would be superior to the delegation of discretionary power to an independent central bank. The reference point for central bank independence in Friedman's analysis was the FED—a central bank with broad discretionary authority and a mandate that lacked clear operational interpretation.<sup>5</sup> In this context,

3. Tucker (2018) presents an insightful analysis of the associated challenges with a focus on central banks.

4. See, in particular, the theoretical contributions by Kydland and Prescott (1977), Barro and Gordon (1983), and Rogoff (1985) and Cukierman (1992) who connected the theory with empirical evidence.

5. The Federal Reserve Act of 1913 instructed the FED to set policy "with a view to accommodating commerce

an independent central bank could make policy too sensitive to personal characteristics and possible biases. Unless policy remains systematic and guided by a well-designed rule, discretionary action by an independent central bank could lead to serious policy errors.

One of the specific concerns expressed by Friedman is what he described as the “technical defect” of splitting macroeconomic policy in an economy among multiple decision makers without sufficient clarity of who is ultimately responsible for the end result—macroeconomic stability and economic welfare. In Friedman’s view, an independent central bank operating with delegated discretionary power could lead to a “dispersal of responsibility, which promotes shirking responsibility in times of uncertainty and difficulty. . .” (Friedman [1968, pp. 177–178]). Friedman drew on the history of the FED for pertinent examples of mismanagement of monetary matters to argue in favor of monetary rules. His article on central bank independence coincided with the completion of his work with Anna Schwartz on the Great Depression—the period reflecting the most serious mistakes in the history of the FED. Friedman suggested that these errors could be attributed to the FED’s independence, at least in part. More specifically, Friedman attributed some policy errors to “accidents of personality.” The extent to which policy is “made highly dependent on personalities” (Friedman [1968, pp. 186–187]), was one of the defects he associated with conducting monetary policy in a discretionary manner through an independent central bank.

In other words, Friedman saw central bank independence with broad discretionary powers not only as insufficient to promote good policy outcomes but as potentially counterproductive “in times of uncertainty and difficulty” (Friedman [1968, pp. 177–178]). Episodes like the Great Depression, the Great Recession, the collapse of a bubble, or major financial crisis—challenging times that require close coordination of monetary, fiscal and other policies, would be periods when central bank independence with broad discretionary authority might lead to problems arising from the undesirable dispersal of responsibility in the management of the macroeconomy.

### III. The Challenge of Unconventional Monetary Policy

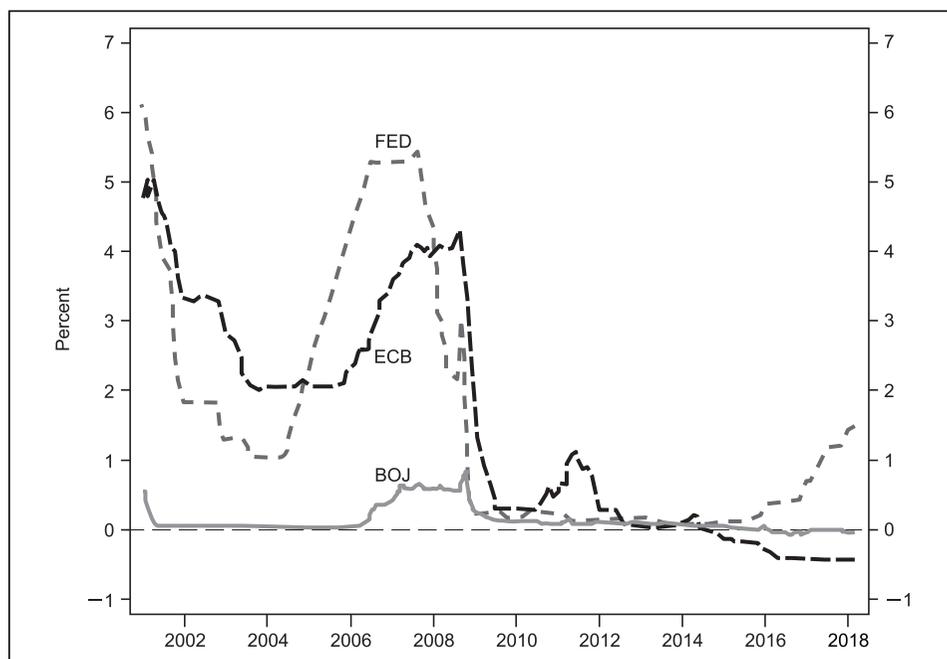
In the aftermath of the 2008 GFC, a number of independent central banks in the advanced economies have faced an extended period of exceptional uncertainty and difficulty, drawing greater attention to their powers and operations. The central banks of the three largest advanced economies, the FED, the ECB, and the BOJ, did not escape unwanted scrutiny. These three central banks face different institutional environments, and somewhat different formulations of objectives and constraints. Nonetheless, all three have operated with considerable degree of independence and a price stability objective since before the crisis, suggesting that contrasting and comparing the challenges they faced would be fruitful.

Figures 1 and 2 compare the monetary policy of the FED, the ECB, and the BOJ

---

and business.” The current formulation, which instructs the FED “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates” was introduced with an amendment to the Act in 1977. A precise definition of price stability as a 2% goal for inflation was adopted in 2012. See Orphanides (2014a), regarding the evolving interpretation of the FED’s mandate.

**Figure 1 Short-Term Interest Rates: FED, ECB and BOJ**



Note: Monthly data. Averages of daily data on the federal funds rate (FED), EONIA (ECB), and overnight call rate (BOJ).

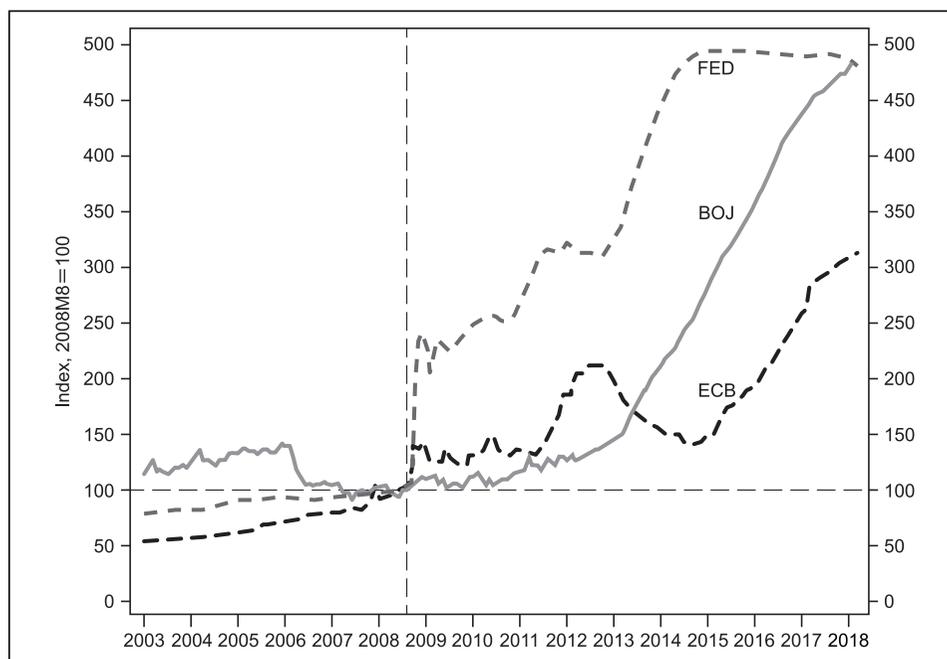
Sources: Board of Governors of the Federal Reserve System (US); European Central Bank; Bank of Japan.

since before the crisis. Several observations are in order. As can be seen in Figure 1, from 2008 on, all three central banks guided short-term interest rates towards zero—the constraint on nominal interest due to the existence of zero-interest-bearing currency notes.<sup>6</sup> The magnitude of the crisis, however, required additional monetary easing that could not be accommodated with further reductions in short-term interest rates. Additional monetary policy easing was required to defend against deflation pressures in each of these three economies. When the room for easing monetary policy with conventional policy tools—interest rate cuts—is exhausted, policy needs to turn to unconventional tools, most importantly quantitative easing policy, implemented by expanding the balance sheet of the central bank through large scale asset purchases. As can be seen in Figure 2, over the past decade, unconventional monetary policy has become the norm. Since 2008, the FED and the BOJ have expanded their balance sheets by a factor of five and the ECB by a factor of three.

From a historical perspective, the massive quantitative easing shown in Figure 2 has been striking. Never before in central bank history have the central banks of the world’s largest advanced economies embarked in such a synchronized quantitative easing. These quantitative easing policies have been controversial. All three central banks have faced criticism for their balance sheet operations. The ECB has even faced le-

6. In practice, the constraint is slightly below zero, and, as can be seen in Figure 1, both the ECB and the BOJ guided short-term interest rates slightly below zero in recent years.

**Figure 2 Size of Balance Sheets: FED, ECB and BOJ**



Note: Monthly data, index equal to 100 in August 2008.

Sources: Board of Governors of the Federal Reserve System (US); European Central Bank; Bank of Japan.

gal challenges that required it to defend its monetary policy decisions in German and European courts. The criticisms have not been identical but have a common thread: Compared to conventional monetary policy, balance sheet operations have more pronounced distributional effects and potentially major fiscal consequences. These attributes bring to light the tremendous force of the balance sheet of the central bank and raise questions of democratic legitimacy and the boundaries of central bank independence. Through control of their balance sheets, central banks of advanced economies have immense fiscal power, one that is not usually associated with technocratic, independent institutions with delegated discretionary authority. Ordinarily, in democratic societies, elected governments are expected to yield fiscal power. Unsurprisingly, large balance sheet operations attract unwanted attention.

Another observation from Figure 2 is that while all three central banks expanded their balance sheets over the past decade, there were significant differences in the evolution of this expansion over time. The FED is notable for embarking on a large expansion very quickly after the 2008 crisis broke. The payoff of its prompt and decisive action has been relative success in maintaining inflation expectations well anchored at around 2% over most of the past decade and successful, albeit slow, reflation of the U.S. economy, which has not yet been achieved by the ECB and the BOJ. As a result of this success, starting in 2015, the FED has been raising interest rates and gradually removing the extraordinary monetary accommodation which it had injected in the U.S. economy after the GFC.

Figure 2 is also suggestive of the intensity of tensions experienced by the ECB in the face of the criticism and legal challenges about its balance sheet expansion. In contrast to the FED, the ECB showed timidity in expanding its balance sheet after 2008 and, inexplicably from an economic perspective, it reversed direction in 2012 while the euro area economy remained under stress: From 2012 to 2014 the ECB was tightening policy by contracting its balance sheet.<sup>7</sup> While policy was eased somewhat further in subsequent years, this policy error resulted in a downward disanchoring of inflation expectations and too-low inflation.

Last but not least, comparing the BOJ to the FED and ECB in Figures 1 and 2 reminds us that the year 2008 was not the beginning of the story of an encounter with the ZLB and quantitative easing for Japan. Indeed, short-term interest rates in Japan have remained close to the zero since before the crisis and two distinct episodes of quantitative easing can be identified in the case of the BOJ. The first was a relatively modest expansion of the balance sheet from 2001 to 2006, while the second has been a more decisive policy that started in 2013 and is still ongoing. Understanding the difference in the two episodes is informative for comparing the challenges faced by the BOJ to those faced by the FED and the ECB. We turn to that next.

#### **IV. The Bank of Japan's Quantitative Easing**

Japan has experienced very low inflation or mild deflation for over twenty years. The origins of the episode can be traced to the collapse of the bubble economy of the 1980s and the slow grind of the deleveraging process required to repair balance sheets and to nurture the troubled banking sector back to health.<sup>8</sup> Depending on how one defines “near-zero” short-term interest rates, the BOJ has faced the ZLB since the mid or late 1990s. As can be seen in Figure 3, the overnight call rate has been at or below half a percent since 1995, and the rate has been very close to zero in most of this period.

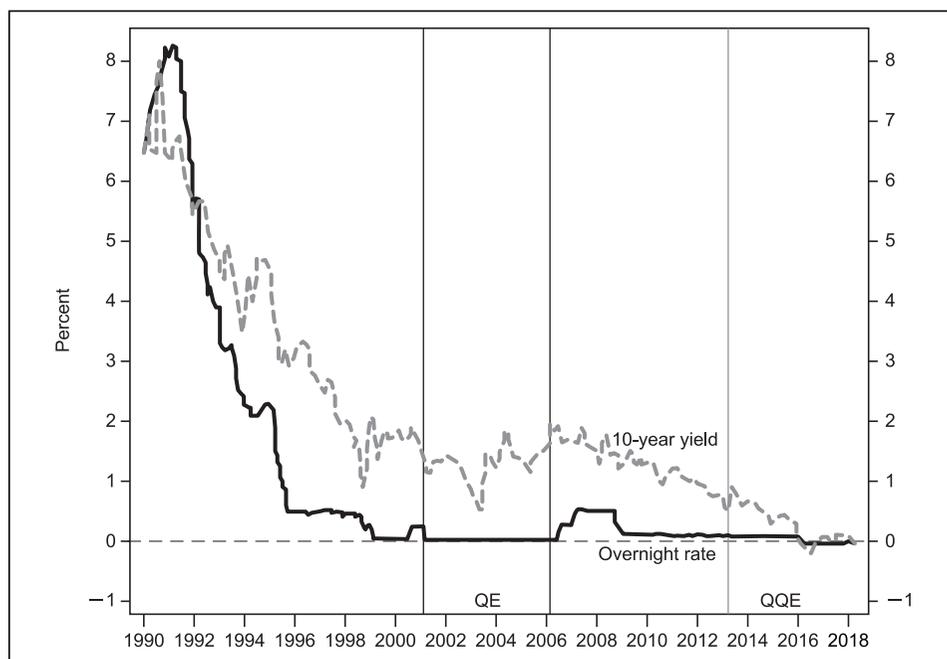
As already discussed, when policy rates are close to zero, it is important to track unconventional monetary policy measures to assess monetary conditions. The level of short-term nominal interest rates is insufficient to describe whether policy is accommodative or not. Comparing the two distinct episodes of BOJ quantitative easing is quite informative regarding their relative effectiveness. The first episode, denoted with “QE” in the figure, lasted about 5 years, from 2001 to 2006. The second episode, marked with “QQE” in the figure, started in 2013 and is continuing.

Overall comparisons of the episodes suggest that policy under QE remained overly tight and that QQE has been more effective in reflating the economy, though continuing accommodation remains necessary to complete the gradual reflation process. The difference in either the stance of monetary policy or its effectiveness, of course, is not evident in short-term rates. Comparing the overnight call rate in the two episodes (Figure 3) suggests hardly any difference at all. The figure also shows two increases in the

7. See Orphanides (2014b) for a more detailed discussion of ECB policy during this period.

8. Numerous studies detail developments in the Japanese economy and financial sector and discuss policy challenges over this period. See, for example, Posen (1998), Cargill, Hutchison, and Ito (2000), Hoshi and Kashyap (1999), Ito and Mishkin (2006) and Ueda (2012). Perspectives from the Bank of Japan staff include Okina, Shirakawa, and Shiratsuka (2001) and Fujiwara *et al.* (2007).

**Figure 3 Overnight Rate and Government Bond Yield**



Note: Vertical lines denote start and end of QE in early 2000s and start of QQE in 2013.

Sources: Bank of Japan; Bloomberg.

overnight call rate, one in 2000 (before QE) and the second in 2006 (after the end of QE and before the GFC), that in retrospect appear to have been premature.<sup>9</sup>

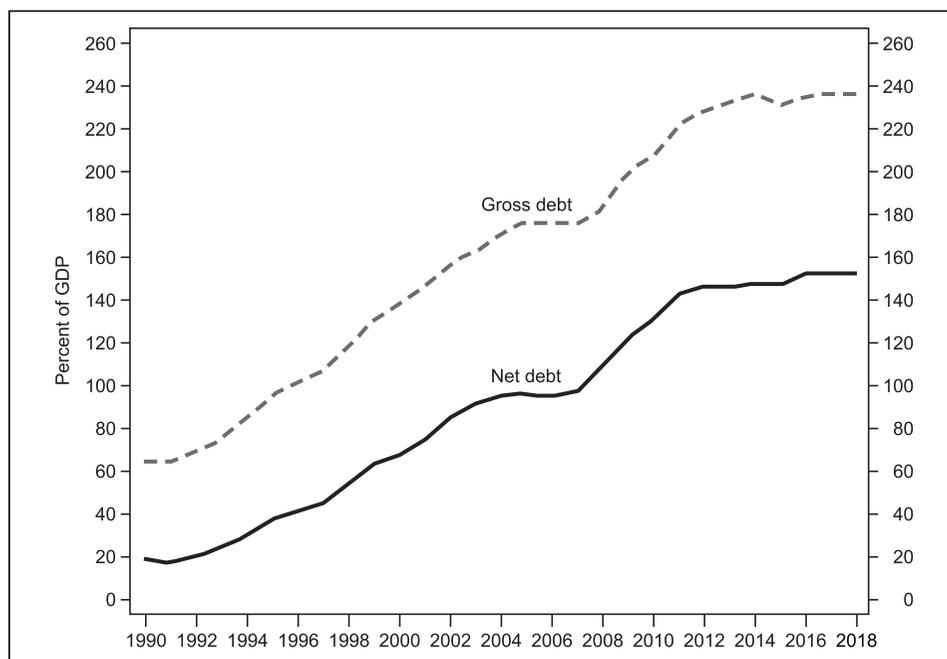
While not visible in the overnight interest rate, the difference in the effectiveness of the two episodes is clearly visible in another interest rate shown in Figure 3: The yield on 10-year government bonds. With QQE, the BOJ has injected additional policy accommodation in the economy by guiding long-term interest rates towards zero. Since September 2016, with the adoption of the Quantitative and Qualitative Easing with Yield Curve Control policy (QQE with YCC), this guidance has become explicit.

The reduction of long-term sovereign yields achieved with QQE is profoundly significant not only because of its monetary policy easing implication but also because of its fiscal implications. One of the ways in which monetary policy can help reflate the economy at the ZLB is by creating fiscal space for the government through lowering the cost of refinancing government debt. To assess the significance of the BOJ's contribution to stabilizing Japan's debt dynamics, consider the determinants of the evolution of debt dynamics summarized in the following equation:

$$\Delta b_t = (r - g)b_{t-1} + d_t,$$

where  $b$  is the debt-to-GDP ratio,  $d$  is the primary-deficit-to-GDP ratio,  $r$  is the real

9. Concerns about the two tightenings were raised in real time, as indicated in the minutes of the BOJ Board meetings. At the August 11, 2000 meeting, for example, two policy board members N. Nakahara and K. Ueda dissented against raising rates.

**Figure 4 Japan's Debt Ratios**

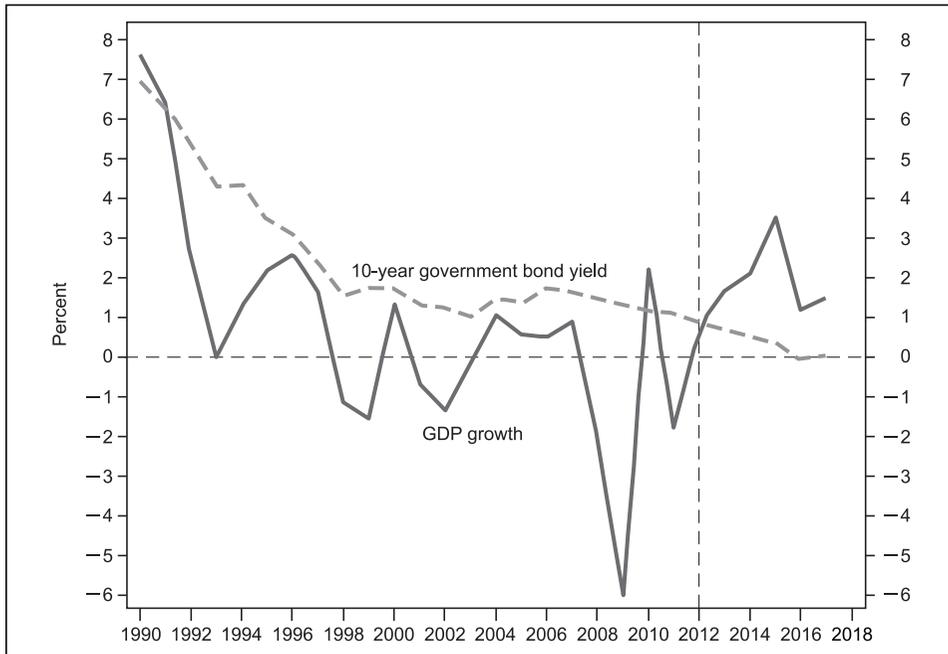
Note: Annual data.

Source: International Monetary Fund.

interest rate on government debt, and  $g$  is the real growth rate of GDP. The evolution of the debt-to-GDP ratio (debt dynamics) is basically driven by two things: the primary deficit of the government ( $d$ ) and the difference between the interest rate and the growth rate of GDP—what is known as the “snowball effect,”  $r-g$ . When the primary deficit is zero, whether the debt ratio rises or falls depends crucially on whether the interest rate ( $r$ ), which reflects the cost of refinancing the debt, is higher or lower than the growth rate in the economy ( $g$ ). One of the major benefits of decisive quantitative easing is the improvement of debt dynamics through the snowball effect. Successfully implemented, quantitative easing raises somewhat the growth rate of GDP and reduces somewhat the cost of refinancing of government debt, improving the snowball effect through both channels.

The effect of BOJ policies on Japan's debt ratios can be shown graphically. Figure 4 plots annual data of the gross and net debt ratios of the Japanese government (as reported by the IMF in the most recent World Economic Outlook database). As can be seen while the two ratios consistently increased from the burst of the bubble until 2013, they have stabilized since then, despite a continuing primary deficit (not shown). The reason for this improvement in debt dynamics is the reversal of the snowball effect, which is approximated in Figure 5 as the difference between nominal GDP growth and the yield on 10-year government debt. As can be seen in the figure, an adverse snowball affect ( $r-g > 0$ ) consistently contributed to the deterioration of debt ratios before QQE, even during the QE period of the early 2000s. By contrast, since

**Figure 5 Japan's Snowball Effect**



Note: Annual data. Vertical line in 2012 denotes year before QQE adoption.

Sources: Cabinet Office, Government of Japan; Bloomberg.

the implementation of QQE, the snowball effect has been supporting the improvement of debt dynamics ( $r - g < 0$ ).

At the ZLB, the lines separating “fiscal” and “monetary” policies become blurred. Fiscal and monetary policies are not identical, but because of the power of the balance sheet to create fiscal space for the government, they can operate in a similarly powerful way. Indeed, in some models, the creation of fiscal space and facilitation of easier fiscal policy than would otherwise be possible is the only effective channel for monetary policy to reflate the economy at the ZLB.<sup>10</sup>

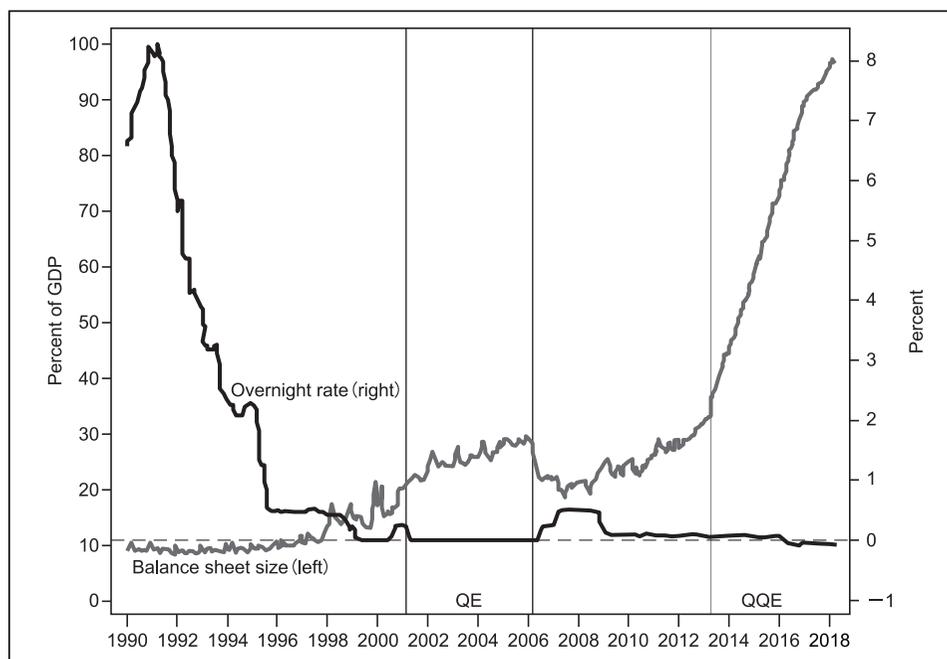
Comparing central banks, the policy easing engineered by the FED also supported US debt dynamics through a favorable snowball effect. The ECB has been implementing its policies in a manner that has supported some member states but not others.<sup>11</sup> In the case of the BOJ, the balance sheet expansion under QE was insufficient to turn an adverse snowball effect into a positive one. As can be seen in Figure 6, which plots the overnight call rate and the BOJ balance sheet as a ratio of GDP, the expansion of the balance sheet under QE was relatively timid. With QQE, this changed. While overnight rates are indistinguishable in the QE and QQE periods, the expansion of the balance sheet under QQE has been more aggressive, reflecting the more decisive monetary policy easing relative to QE.

Figure 7 superimposes the 10-year government bond yield and the contribution of

10. See the discussion in Sims (2016) regarding the policy implications of the fiscal theory of the price level.

11. See Orphanides (2017) for a comparison of the fiscal implications of FED, BOJ, and ECB policies.

**Figure 6 Japan’s Conventional and Unconventional Policy**



Note: Vertical lines denote start and end of QE in early 2000s and start of QQE in 2013. Monthly balance sheet ratio (left axis) constructed using quarterly GDP.

Sources: Bank of Japan; Cabinet Office, Government of Japan.

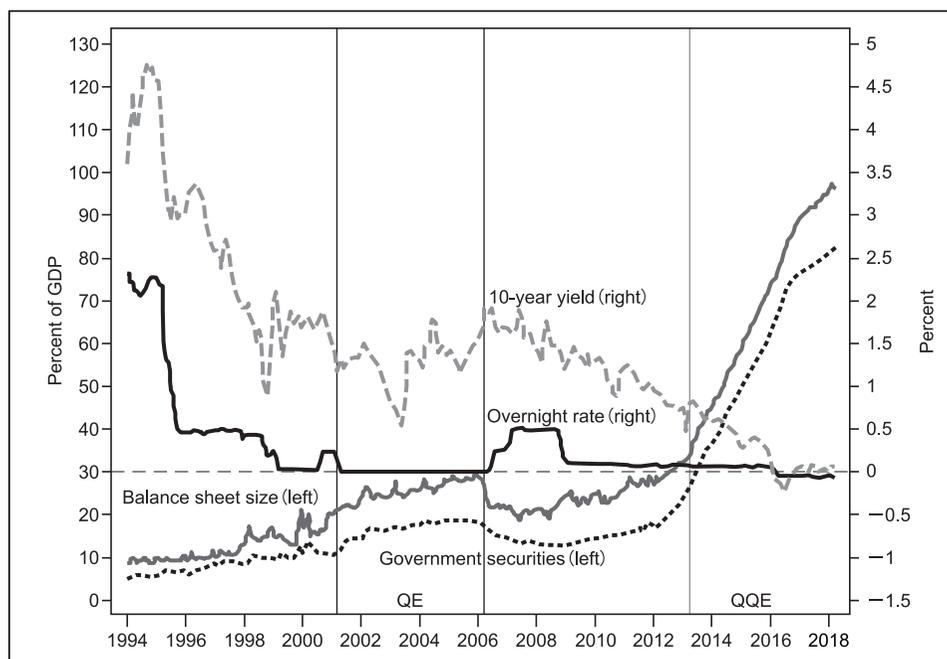
holdings of government securities in the BOJ balance sheet on the two policy instruments shown in Figure 6. The additional detail is informative about the mechanics of the policy easing under QQE and the notable decline in long-term government bond yields. Under QQE, most of the increase in the size of the BOJ balance sheet can be attributed to purchases of government securities. Holdings of government securities have increased from about 25% of GDP to about 80% of GDP and are expected to grow further. In comparison, during the QE episode, holdings increased from about 10% to less than 20% of GDP.

Recognizing a significant difference between QE and QQE, both in terms of easing and in terms of effectiveness invites another question: What explains the relative timidity of BOJ policy at the turn of the century? Why did the BOJ not adopt earlier the policy easing that was implemented with QQE? What were the key differences in the two episodes?

## V. Unconventional Monetary Policy Measures

Before addressing the questions above, it is useful to recall that many observers, both in Japan and outside Japan, considered BOJ policy at the turn of the century to be overly restrictive. As McCallum (2003) observed at the time: “It is hard to avoid the impression that Bank of Japan (BOJ) policy has been overly restrictive for approxi-

**Figure 7 The Bank of Japan's Balance Sheet and Interest Rates**



Note: Vertical lines denote start and end of QE in early 2000s and start of QQE in 2013. Monthly ratios of the BOJ balance sheet and government securities holdings (left axis) constructed using quarterly GDP.

Sources: Bank of Japan; Cabinet Office, Government of Japan; Bloomberg.

mately a decade.” (p. 1) One potential explanation could be that monetary policy was believed to have reached its limits. To dispel this fallacy (which is not uncommon at the ZLB), McCallum went on to state: “It is not true that there has been ‘nothing more that the BOJ can do,’ what needs to be done is different than in normal conditions and the policy actions are more difficult to design.”

Effectively, McCallum, who at the time served as an honorary adviser of the BOJ’s Institute for Monetary and Economic Studies, was reminding the BOJ that if the BOJ wanted more monetary accommodation it could have more monetary accommodation. This may have been more difficult to design than lowering the policy rate, but was feasible nonetheless. Indeed, even before the turn of the century, at about the time the BOJ first encountered the ZLB, numerous proposals had been advanced to help the BOJ overcome it.

Friedman (1997) and Meltzer (1998) suggested monetary expansion—quantitative easing. Krugman (1998), Posen (1998), and Bernanke (1999) suggested the adoption of a higher inflation target. At the time, the BOJ interpreted price stability as approximately zero measured CPI inflation. Bernanke (1999), in particular, advised that since most other central banks had inflation targets around 2%, if the BOJ decided to move in that direction, it would represent a welcome policy easing while maintaining consistency with global norms of price stability. McCallum (2000) and Svensson (2001) suggested policies focused on weakening the exchange rate, a “foolproof” approach in

Svensson's view, which however could invite political difficulties in global affairs by inviting criticism that Japan was engaging in competitive devaluation. Other proposals included Goodfriend (2000), who suggested working towards implementing negative policy interest rates and Orphanides and Wieland (2000), who argued that with the overnight rate at zero the central bank could ease policy further by bringing successively longer-maturity rates to zero, flattening the term structure of interest rates as much as needed.

Interestingly, in one way or another, many of these suggestions were eventually implemented by the BOJ, as part of the policy framework that has been adopted with QQE. But at the turn of the century, the BOJ appeared reluctant to engineer the monetary policy accommodation that so many observers believed was needed.

It is worth recalling the specific advice offered at the time by Milton Friedman and Allan Meltzer. Being among the former honorary advisers of the BOJ's Institute for Monetary and Economic Studies, Friedman and Meltzer had been independently following BOJ policy closely. On December 17, 1997, Friedman (1997) wrote:

“The Bank of Japan can buy government bonds on the open market, paying for them with either currency or deposits at the Bank of Japan, what economists call high-powered money. . . . There is no limit to the extent to which the Bank of Japan can increase the money supply if it wishes to do so. Higher monetary growth will have the same effect as always. After a year or so, the economy will expand more rapidly; output will grow; and after another delay, inflation will increase moderately.”

A few months later, on July 17, 1998, Meltzer (1998) noted further that monetary expansion, by raising asset prices, would have the added benefit of strengthening the banking system, thus tackling another concern facing Japanese authorities:

“Monetary expansion and devaluation is a much better solution. . . . An announcement by the Bank of Japan and the government that the aim of policy is to prevent deflation and restore growth by providing enough money to raise asset prices would change beliefs and anticipations. Rising asset prices, including land and proper[ty] prices, would revive markets for these assets once the public became convinced that the policy would be sustained.

The volume of bad loans at Japanese banks is not a fixed sum. Rising asset prices would change some loans from bad to good, thereby improving the position of the banking system. Faster money growth would add to the banks' ability to make new loans, encouraging business expansion.”

After these suggestions were made, in 1999, the BOJ did slightly ease policy by introducing the Zero Interest Rate Policy (ZIRP); however, the calls to employ the power of its balance sheet went unheeded.

One possible reason for the reluctance to implement quantitative easing policies may have been that, at the time the BOJ encountered the ZLB, experience with balance sheet policies was rather limited. However, the difficulties associated with the ZLB were not entirely novel: The ZLB problem and the solution of quantitative easing had already been suggested as early as 1930 by John Maynard Keynes, and, in the case of

the FED was eventually implemented (following a catastrophic delay and policy errors associated with the Great Depression). Reflecting on the theoretical possibility of engineering additional policy easing at the ZLB, Keynes (1930) had already suggested clearly what later became known as quantitative easing:

“My remedy in the event of the obstinate persistence of a slump would consist, therefore, in the purchase of securities by the Central Bank until the long-term market-rate of interest has been brought down to the limiting point . . .

It should not be beyond the power of a Central Bank (international complications apart) to bring down the long-term market-rate of interest to any figure at which it is itself prepared to buy long-term securities.”

At the time Keynes was writing, quantitative easing was novel and untested, but in essence Keynes’ prescription was quite modern: The ZLB could be circumvented with sufficient purchases of long-term government debt, whose yields could be reduced as low as needed by using the power of the balance sheet.

## VI. Central Bank Independence and the Bank of Japan Act

At the turn of the century, the BOJ had the available tools to implement the policy accommodation that was later adopted with QQE and was offered specific advice to that effect. And yet policy hardly moved beyond ZIRP. QE in the early 2000s proved far too timid. What hindered BOJ policy?

One complication relates to a change in the law. The BOJ Act was significantly amended in 1997, with the change taking effect in 1998, just as the BOJ was about to encounter the ZLB. The new law had positive elements: It formally transformed the BOJ into an independent central bank and explicitly recognized price stability as the Bank’s main objective. However, it also had weaknesses: It offered no clarity on the precise definition of price stability and provided insufficient guidance about how to deal with unconventional policy. In effect, the new Act created an independent central bank susceptible to concerns such as those Friedman had expressed in 1962.

To be sure, a change in the BOJ law, which had been little changed from the 1942 Bank of Japan Act, had been long overdue. By the 1990s, in the aftermath of the collapse of the bubble economy, it was considered essential. To understand the need for change, it suffices to revisit some of its provisions.<sup>12</sup>

Under the old law, the objective of the bank, stated in Article 2, was very broad: “The Bank of Japan shall be managed solely for achievement of national aims.” Its discretionary authority and leeway for independent actions were severely limited. According to Article 43, “The competent Minister may, if deemed particularly necessary for the attainment of the object of the Bank of Japan, order the Bank to undertake any necessary business, or order alterations in the By-Laws as well as other necessary actions.” And according to Article 47: “Whenever the actions of the officers of the Bank of Japan contravene the laws . . . or orders of the competent Minister, . . . they may be dismissed . . .” Under the old law, the Bank was effectively under the total control of

12. Cargill, Hutchison, and Ito (2000) present a more detailed analysis of the Bank of Japan Act.

the Ministry of Finance, a situation that was at odds with the global wave of the 1980s and 1990s towards granting central banks greater independence.

Following the 1997 revision in the Bank of Japan Act, the legislation was brought closer to that of other central banks. The objective of the Bank was modernized as follows: “Currency and monetary control by the Bank of Japan shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy.” (Article 2). This is similar to formulations associated with some inflation targeting central banks and the language in the European Union Treaty, which defines the mandate of the ECB and forms the basis for the objective of most other central banks in Europe. Finally, Article 3 of the revised act establishes the Bank’s independence: “The Bank of Japan’s autonomy regarding currency and monetary control shall be respected.”

But how did the change of the Act influence policy at the turn of the century? Two factors explain the problem. The first, and most important, was the lack of clarity regarding the definition of price stability—the bank’s primary objective. Lack of clarity regarding the definition of price stability meant that BOJ Board members could use their discretion to define what price stability meant. Achieving and maintaining measured CPI inflation of +1% or 0% or  $-1/2\%$ , could all be plausibly seen as appropriate definitions of price stability, in the sense of meeting the Bank’s goals according to the Act. Of course, these alternative interpretations implied considerably different settings for monetary policy.

Reading through minutes of the BOJ’s Monetary Policy Meeting in that period, a number of the Board members appear to have interpreted the mandate of the Bank as zero measured CPI inflation. Admittedly, such an interpretation was not unreasonable. Nonetheless, arguments to the contrary were also available. According to Shiratsuka (1999), the measurement bias in Japan’s CPI at the time was around one percentage point. If the goal was to achieve “true” price stability, wouldn’t a 1% inflation target be more appropriate? And considering the problems associated with the ZLB, wouldn’t an additional small margin be advisable, suggesting, for example, a 2% inflation target as a more reasonable definition of price stability?

Since complications of the ZLB had not yet been adequately studied at that time, perhaps the ZLB argument for considering an inflation target close to 2% would not have been convincing. But, as had been discussed by Ben Bernanke, the central banks of other large advanced economies had implicit or explicit inflation goals close to 2%. Wouldn’t it be useful if the BOJ adopted a similar interpretation of price stability?

In retrospect, the timing of the change of the BOJ Act proved unfortunate: The BOJ faced the ZLB right at the time the Act came into effect. The challenge of having to consider implementing unconventional policies—with all the political pitfalls and associated criticisms—appeared right at the time the BOJ had to establish its reputation as an independent central bank. As Cargill, Hutchison, and Ito (2000, p. 173) observed, the BOJ found itself in an “independence trap” and adopted unnecessarily conservative policies that proved too restrictive for the macroeconomic conditions facing Japan at the turn of the century.

Would BOJ policy have been different, had the new law clarified a framework for defining price stability as a symmetric 2% goal for CPI inflation? Clearly, policy would have been more accommodative. However, the new Act did not include a provision

that could clarify the precise meaning of price stability. A formal definition of the primary goal of monetary policy as achieving and maintaining 2% inflation could have been incorporated in the legislation, or alternatively, as part of an associated Policy Targets Agreement (PTA), similar to practices encountered in some inflation targeting central banks.<sup>13</sup> The definition of price stability could have been jointly set with the government at the time. But it was not. At the turn of the century, the lack of clarity in the BOJ Act was interpreted as giving the BOJ the discretionary authority to define the meaning of price stability on its own, leading to an interpretation that resulted in mild deflation.

The second complication with the newfound independence of the BOJ was insufficient guidance about how to deal with unconventional policy, more precisely a concern about the solvency of the BOJ and the reputational risk associated with possible losses that might materialize from engaging in large scale balance sheet operations. Though this may appear esoteric, it posed a nontrivial concern for the newly independent central bank. This can be appreciated by reading the minutes of BOJ Board discussions as well as speeches by members of the Board, such as Ueda (2003). The issue relates to accounting practices in central banking, which vary widely across countries. As Archer and Moser-Boehm (2013) point out in their comprehensive review of the matter, even though differences in accounting practices should not in principle influence policy decisions relating to a central bank's fundamental objectives, in practice they do, by influencing incentives and policy-maker behavior.

At the BOJ, the issue arose at the turn of the century because the ZLB necessitated consideration of unconventional monetary policy measures, such as large scale purchases of government debt. Unconventional policy requires that the central bank take greater accounting risk on its balance sheet. How should an independent central bank with limited capital treat this risk? One challenge is the asymmetry in the treatment of profits and losses. A central bank engaging in large scale purchases of long-term government debt may initially register unusually large profits that would be expected to be turned over to the Treasury. But success in reflation creates the risk of depressing the valuation of the bonds on the central bank's balance sheet. The bank might be faced with substantial losses if it implements the appropriate reflation policy. How should these losses be dealt with?

In theory, such concerns can be dealt with by looking at the consolidated balance sheet of the central bank and the government, internalizing potential tensions resulting from unconventional monetary policy. In the case of the newly independent BOJ, and absent guidance in the legislation, initiating such discussions could have been seen as potentially compromising the BOJ's independence. Furthermore, the legitimacy of the BOJ assuming significant additional risks on its balance sheet was unclear when the new Act was enacted. As Ueda (2003) pointed out, the BOJ was already taking more risk on its balance sheet than what would have ordinarily been expected. The BOJ had even engaged in purchases of corporate equities. Ueda (2003) suggested that reaching

.....  
13. This practice originated with the Reserve Bank of New Zealand Act of 1989 and marked the beginning of inflation targeting. The Policy Targets Agreement served as a contract between the government and the Governor. See Walsh (1995) for the theoretical foundations of optimal contracts for central banks with delegated discretionary authority.

an understanding with the Ministry would have been advisable if the BOJ were to assume greater risks, so as to ensure the legitimacy of its actions.

The two complications were interrelated. By using its discretionary authority to interpret price stability as corresponding to 0% rather than 2% inflation, the BOJ could avoid the aggressive balance sheet expansion that would have been required to achieve 2% inflation and thus sidestep concerns about taking additional risk on its balance sheet. Had the Bank not faced the need for unconventional measures, it would have likely eased monetary policy more appropriately at the turn of the century and accommodated a positive rate of measured CPI inflation as its price stability goal. Alternatively, the willingness of the BOJ to engage in large scale purchases of government debt at the turn of the century could have been greater, had the new law clarified from the outset the treatment of balance sheet risk associated with unconventional policy.

## **VII. Refining the Boundaries of BOJ Independence**

A critical step forward was made in 2013, opening the way for the decisive QQE policy that started that year. A joint statement was issued by the government and the BOJ on January 22, 2013. As explained in the press release: “The Government and the Bank of Japan decided to release the attached statement jointly. They will strengthen their policy coordination in order to overcome deflation and achieve sustainable economic growth.” An important element of the joint statement was the clarification of the definition of price stability as a 2% target for measured CPI inflation:

“The Bank of Japan conducts monetary policy based on the principle that the policy shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy . . . the Bank sets the price stability target at 2 percent in terms of the year-on-year rate of change in the consumer price index.” (Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth. January 22, 2013, Cabinet Office, Ministry of Finance, Bank of Japan.)

This clarification removed the ambiguity associated with the interpretation of the primary goal of the BOJ. Consequently, it also implicitly allayed concerns regarding the legitimacy of assuming balance sheet risks that would be necessary to achieve this goal.

Providing a precise operational definition of price stability with a joint declaration by the BOJ and the government served a similar role to that of a PTA in inflation-targeting central banks. In one sense, the joint declaration could be viewed as constraining the BOJ’s independence in a particular way: It weakened the discretionary authority of the BOJ to interpret its primary operational objective on its own. But in another sense, it strengthened the independence of the central bank by removing concerns regarding the legitimacy of its actions.

The joint statement issued by the BOJ and the government in January 2013, moved the BOJ closer to the paradigm of goal dependence and instrument independence, that DeBelle and Fischer (1994) had concluded was likely closest to best practice. In this sense, the joint statement improved the institutional arrangement that had been intro-

duced with the 1997 law.

Interestingly, this potential improvement had been identified by the IMF at the time the law was under discussion in Japan. This occurred in the context of the Article IV Consultation with Japanese authorities that took place in May 1997. To its credit, the IMF identified the lack of precision in the definition of the BOJ objectives as a weakness in the proposed law and made constructive suggestions. In discussing the law, IMF staff noted:

“The staff argued that the benefits of formal BOJ independence would be reinforced by setting transparent, quantitative goals for the ultimate objectives of monetary policy. . . . Furthermore, setting a lower bound on the target inflation rate of, say, 1 percent would provide a useful buffer against the emergence of deflationary pressures.” (IMF [1997, p. 28])

The new Act, which was passed by the Diet in June 1997, did not incorporate the IMF recommendation. But this was effectively done with the joint statement in January 2013.

## VIII. Concluding Remarks

Can a central bank be too independent? Recognizing the limits, Fischer (1995, p. 205) answered as follows:

“The answer is yes. As a matter of theory, both of the basic analytic models of central banking imply that the central banker can be too inflation-averse, and too insensitive to the possibilities of stabilizing output. Further, there are potential benefits from the coordination of monetary and fiscal policy that may be forgone when the central bank is independent.”

The experience of the BOJ over the past two decades lends support to this answer and suggests valuable lessons.

The BOJ Act, which transformed the BOJ into an independent central bank with a price stability mandate, had positive elements but also weaknesses that hampered policy at the turn of the century. The law took effect in 1998, just as the BOJ was about to encounter the ZLB. Lack of clarity on the precise definition of price stability coupled with a preference to limit the risk assumed on its balance sheet, made the BOJ reluctant to engage in the decisive quantitative easing that was needed to reflate the economy and instead willing to accommodate too-low inflation. A dramatic reorientation of monetary policy took place in 2013, following a joint statement by the government and BOJ that clarified the definition of price stability as a 2% target for measured CPI inflation. The decisive QQE policy that started that year has been gradually reflating the economy while simultaneously creating fiscal space for the government and improving Japan’s sovereign debt dynamics.

The BOJ experience also points to lessons for other independent central banks challenged by the ZLB, such as the ECB. Similar to the BOJ, the ECB started operating in 1998 as an independent central bank with a price stability mandate lacking a precise

definition. Interestingly, in 2003, the ECB adopted a “clarification” interpreting price stability as inflation “below but close to 2%,” citing the ZLB as one of the reasons.<sup>14</sup> And yet, when faced with the ZLB and potential criticism of quantitative easing policies, the ECB eschewed the decisive balance sheet expansion necessary to maintain inflation “close to 2%” and instead accommodated too-low inflation. The BOJ experience suggests that the euro area would benefit if the ECB adopted a more precise definition of price stability—a symmetric 2% inflation goal.

While an independent central bank with a price stability mandate is an appealing institutional arrangement for monetary policy, care is needed in its design. Concerns such as those expressed by Friedman in 1962 remain highly relevant. Independence with broad discretionary authority and a mandate that lacks clear operational interpretation could potentially prove counterproductive, especially in challenging times, when coordination of monetary, fiscal, and other policies may be most important. Independence should protect monetary policy from short-term political interference. It should also ensure that monetary policy is systematic and not highly dependent on personalities. The discretionary authority delegated to an independent central bank should not promote shirking responsibility in challenging times. This requires clear, transparent goals, promoting accountability and democratic legitimacy.

.....  
14. This was communicated at the associated press briefing on May 8, 2003. See Issing (2003a) and the associated studies in Issing (2003b).

## References

- Archer, David, and Paul Moser-Boehm, "Central Bank Finances," BIS Papers, No. 71, Bank for International Settlements, 2013.
- Barro, Robert J., and David B. Gordon, "Rules, Discretion and Reputation in a Model of Monetary Policy," *Journal of Monetary Economics*, 12(1), 1983, pp. 101–121.
- Bernanke, Ben S., "Japanese Monetary Policy: A Case of Self-Induced Paralysis?" for presentation at the ASSA Meetings, in Boston on January 9, 2000, December 1999.
- Cargill, Thomas F., Michael M. Hutchison, and Takatoshi Ito, *Financial Policy and Central Banking in Japan*, Cambridge, Massachusetts: The MIT Press, 2000.
- Cukierman, Alex, *Central Bank Strategy, Credibility, and Independence: Theory and Evidence*, Cambridge, Massachusetts: The MIT Press, 1992.
- Debelle, Guy, and Stanley Fischer, "How Independent Should a Central Bank Be?" in Jeffrey C. Fuhrer, ed. *Goals, Guidelines, and Constraints Facing Monetary Policymakers*, Federal Reserve Bank of Boston Conference Series No.38, Federal Reserve Bank of Boston, 1994, pp. 195–221.
- Fischer, Stanley, "Central-Bank Independence Revisited," *American Economic Review*, Papers and Proceedings, 85(2), 1995, pp. 201–206.
- Friedman, Milton, "Should There Be an Independent Monetary Authority?" in Leland B. Yeager, ed. *In Search of a Monetary Constitution*, Cambridge, Massachusetts: Harvard University Press, 1962. Reprinted in Friedman, Milton, *Dollars and Deficits*, Englewood Cliffs: Prentice Hall, 1968.
- , "Rx for Japan: Back to the Future," *Wall Street Journal*, December 17, 1997.
- Fujiwara, Ipppei, Naoko Hara, Naohisa Hirakata, Takeshi Kimura, and Shinichiro Watanabe, "Japanese Monetary Policy during the Collapse of the Bubble Economy: A View of Policymaking under Uncertainty," *Monetary and Economic Studies*, 25(2), Institute for Monetary and Economic Studies, Bank of Japan, 2007, pp. 89–128.
- Goodfriend, Marvin, "Overcoming the Zero Bound on Interest Rate Policy," *Journal of Money, Credit and Banking*, 32(4), 2000, pp. 1007–1035.
- Hoshi, Takeo, and Anil Kashyap, "The Japanese Banking Crisis: Where Did It Come from and How Will It End?" *NBER Macroeconomics Annual*, 14, 1999, pp. 129–201.
- International Monetary Fund, "Staff Report for the 1997 Article IV Consultation," International Monetary Fund, 1997.
- Issing, Otmar, "Evaluation of the ECB's Monetary Policy Strategy," presentation at the Press Seminar on the Evaluation of the ECB's Monetary Policy Strategy, European Central Bank, Frankfurt, May 8, 2003a (available at: [https://www.ecb.europa.eu/press/pressconf/2003/html/is030508\\_1.en.html](https://www.ecb.europa.eu/press/pressconf/2003/html/is030508_1.en.html) accessed July 30).
- , ed., *Background Studies for the ECB's Evaluation of its Monetary Policy Strategy*, European Central Bank, Frankfurt, 2003b.
- Ito, Takatoshi, and Frederic S. Mishkin, "Two Decades of Japanese Monetary Policy and the Deflation Problem," in Takatoshi Ito and Andrew K. Rose, eds. *Monetary Policy under Very Low Inflation in the Pacific Rim*, Chicago: University of Chicago, 2006.
- Keynes, John M., *A Treatise on Money Volume 2: The Applied Theory of Money*, London: Macmillan, 1930.
- Krugman, Paul R., "It's Baaack! Japan's Slump and the Return of the Liquidity Trap," *Brookings Papers on Economic Activity*, 2, 1998, pp. 137–187.
- Kydland, Finn E., and Edward C. Prescott, "Rules Rather than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy*, 85(3), 1977, pp. 473–492.
- McCallum, Bennett T., "Theoretical Analysis Regarding a Zero Lower Bound on Nominal Interest Rates," *Journal of Money, Credit and Banking*, 32(4), 2000, pp. 870–904.
- , "Japanese Monetary Policy, 1991–2001," *Federal Reserve Bank of Richmond Economic Quarterly*, 89(1), 2003, pp. 1–31.
- Meltzer, Allan H., "Time to Print Money," *Financial Times*, July 17, 1998.

- Okina, Kunio, Masaaki Shirakawa, and Shigenori Shiratsuka, "The Asset Price Bubble and Monetary Policy: Japan's Experience in the Late 1980s and the Lessons," *Monetary and Economic Studies*, 19(S-1), Institute for Monetary and Economic Studies, Bank of Japan, 2001, pp. 395–450.
- Orphanides, Athanasios, "The Need for a Price Stability Mandate," *Cato Journal*, 34(2), 2014a, pp. 265–279.
- , "European Headwinds: ECB Policy and Fed Normalization," CEPR Policy Insight No. 74, Centre for Economic Policy Research, 2014b.
- , "Fiscal Implications of Central Bank Balance Sheet Policies," in Ludovit Odor, ed. *Rethinking Fiscal Policy after the Crisis*, Cambridge: Cambridge University Press, 2017, pp. 71–100.
- , and Volker Wieland, "Efficient Monetary Policy Design near Price Stability," *Journal of the Japanese and International Economies*, 14(4), 2000, pp. 327–365.
- Posen, Adam S., *Restoring Japan's Economic Growth*, Washington, D.C.: Peterson Institute for International Economics, 1998.
- Rogoff, Kenneth, "The Optimal Degree of Commitment to an Intermediate Monetary Target," *Quarterly Journal of Economics*, 100(4), 1985, pp. 1169–1189.
- Shiratsuka, Shigenori, "Measurement Errors in the Japanese Consumer Price Index," *Monetary and Economic Studies*, 17(3), Institute for Monetary and Economic Studies, Bank of Japan, 1999, pp. 69–102.
- Sims, Christopher A., "Fiscal Policy, Monetary Policy and Central Bank Independence," paper presented at the Federal Reserve Bank of Kansas City's Economic Policy Symposium on "Designing Resilient Monetary Policy Frameworks for the Future," in Jackson Hole on August 25–27, 2016.
- Svensson, Lars E. O., "The Zero Bound in an Open Economy: A Foolproof Way of Escaping from a Liquidity Trap," *Monetary and Economic Studies*, 19(S-1), Institute for Monetary and Economic Studies, Bank of Japan, 2001, pp. 277–312.
- Tucker, Paul, *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State*, Princeton: Princeton University Press, 2018.
- Ueda, Kazuo, "Japan's Experience with Zero Interest Rates," *Journal of Money, Credit and Banking*, 32(4-2), 2000, pp.1107–1109.
- , "The Role of Capital for Central Banks," speech at the Fall Meeting of the Japan Society of Monetary Economics on October 25, 2003.
- , "Japan's Deflation and the Bank of Japan's Experience with Nontraditional Monetary Policy," *Journal of Money, Credit and Banking*, 44(s1), 2012, pp.175–190.
- Walsh, Carl E., "Optimal Contracts for Central Bankers," *American Economic Review*, 85(1), 1995, pp. 150–167.
- Williams, John C., "Monetary Policy at the Zero Lower Bound: Putting Theory into Practice," Hutchins Center on Fiscal & Monetary Policy, Brookings, January 2014.

