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The Separation of Monetary and Fiscal Policy – A Golden Rule for the Bank of Japan?

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1. Introduction

> "The happy truth is that monetary policy is not very controversial – and is certainly not very political [...] debates over monetary policy are now apt to be boring and technical – and far removed from politics."[1]

Former Federal Reserve Vice Chairman Alan Blinder could not have been more misspoken if he were making an observation about Japan. After an unprecedented three-week leadership vacuum at the Bank of Japan (hereafter BOJ)'s top post, Masaaki Shirakawa has been appointed as the bank's new Governor. The anomalous hiatus, in the midst of a global financial market crisis, generated severe criticism about the inabilities of Japan's politicians. The Democratic Party of Japan (hereafter DPJ), who controls the upper chamber of the National Diet, and is the main opposition to Japan's ruling Liberal Democratic Party (hereafter LDP) repeatedly rejected nominees submitted by the coalition government led by LDP. The DPJ's key argument is that a Ministry of Finance (hereafter MOF)-backed Governor threatens the separation of monetary and fiscal policy and the Central Bank's independence. This Newsletter investigates whether or not this argument is justified.

[1] Alan S. Blinder (2005): Are the Fed Fights over? *The New York Times*, November 20.

2. “Horror vacui”[2] – The drawn-out battle of the nomination process

> “The possibility that the authorities could be both truthful and competent is barely worth considering."[3]

Central banks are “governmental entities that possess and exercise some grant of specialized public authority […] but are neither directly elected by the people, nor directly managed by elected officials”.[4] Although politicians’ control over monetary policy has decreased over time, lawmakers can appoint central bank leaders, and thus indirectly influence monetary policy decisions.[5]

With the clock ticking on the expiration of BOJ governor Fukui's five-year term on March 19, the Japanese government nominated Deputy Governor Toshiro Muto, Takatoshi Ito, a professor at the University of Tokyo, and Masaaki Shirakawa, a former BOJ Executive Director, as Governor and two Deputy Governors respectively. The opposition-controlled upper house confirmed only Shirakawa.[6] Before the DPJ became the largest party in the House of Councilors in July 2007, Muto had been widely considered the person to become the new BOJ Governor, and since joining the BOJ in 2003, he had been groomed by Fukui to be his successor. Widely known as “Balance Muto”, a name referring to his remarkable reliance among the country’s technocrats, businessmen, and legislators, he has a strong reputation in banking and financial circles. The rationale behind Muto’s refusal was his 37 year long career at the finance ministry, including tenure as Administrative Finance Minister.

The government’s second candidate for governorship Koji Tanami, Governor of the Japan Bank for International Cooperation, was rejected for the same reason as Muto,[7] whereas Kiyohiko Nishimura, a Monetary Policy Board member since 2005, was accepted as Deputy Governor. As a result, when Fukui stepped down, the bank was without an official leader and Deputy Governor Shirakawa took place as acting Governor. Early in April Shirakawa was nominated as Governor of the BOJ and after

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2 (Engl. Nature Abhors a Vacuum) Aristotle, circa 350 B.C.

3 Willem H. Buiter (2007): Truth and Competence, *The Financial Times*, December 4. http://blogs.ft.com/maverecon/2007/12/truth-and-compehtml/

4 Marc Thatcher and Alec Stone Sweet (2002): Theory and Practice of Delegation to Non-Majoritarian Institutions, *West European Politics*, Vol. 25, No. 1, pp. 1-22.

5 Kelly H. Chang (2003): *Appointing Central Bankers: The Politics of Monetary Policy in the United States and the European Monetary Union*. Cambridge: University Press.

6 In terms of legislation the House of Representatives can overrule a rejection by the House of Councilors with a two-thirds majority vote (Article 59 of the Constitution). However, this regulation is not valid for the appointment of BOJ’s top positions such as the Governor, Deputy Governors, and Monetary Policy Board members. Article 23 of the BOJ law requires the approval of both Diet chambers.

7 Tanami arrived at the MOF in 1964 and served as Vice Finance Minister from January 1998 to July 1999.

the upper house' approval on April 9, the stalemate over the leadership vacuum at the bank's helm has finally ended. On the contrary, Watanabe, a nominee for the Deputy Governor post, was blocked. The opposition disapproved with Kazuhito Ikeo, a Keio University professor, another candidate for the monetary policy board. It should be noted that Ikeo is without any ties to the Ministry of Finance. The position of one Deputy Governor together with one seat in the Monetary Policy Board still remains vacant, and the battle is not over yet.

Figure 1: The nomination process

	Governor	Deputy Governor	Policy board	Nomination	Appointment
1	Muto (MoF)	Ito and Shirakawa		March 7	March 13
2	Tanami (MoF)	Nishimura		March 18	March 20
3	Shirakawa	Watanabe (MoF)		April 7	April 9
4			Ikeo	May 29	Upper House did not vote

(**Note**: The candidates marked in red were rejected)

The anomalous hiatus at the BOJ's top post and the unfilled Monetary Policy Board are a rather unfavorable situation. In fact, all governments make sure that their central bank has a suitable Governor at all times. One rare exception occurred in Italy when Governor Antonio Fazio stepped down from his lifetime appointment in December 19, 2005. After twelve years in office Fazio was forced to resign, stumbling over his handling of a controversial bank takeover. He attempted to hinder two foreign banks in their purchase of Italian lenders. His successor Mario Draghi, a former Director General of the Italian Treasury and Vice Chairman of Goldman Sachs International, took over ten days later.

3. The "Do right, though the heavens fall"[8] attitude to keeping monetary and fiscal policy separate

> "The central bank is always an agent of the state, even if it is not an agent of the government. […] without effective communication, co-operation and coordination with the fiscal authorities, central bank independence does not deserve to, and will not, survive."[9]

We have observed the rejection of two former high-ranking officials of the Ministry

[8] The anti-inflationary color of the German Bundesbank was sometimes described with this slogan.

[9] Willem H. Buiter (2004): Two naked emperors? Concerns about the Stability & Growth Pact and second thoughts about central bank independence. London: LSE Research Online, p. 38-39. http://eprints.lse.ac.uk/archive/00000846.

of Finance as candidates for the job of Governor of the BOJ. Likewise, two nominees for the job of Deputy Governor, and one candidate for the Monetary Policy Board had been blocked. But the DPJ's viewpoint remains enigmatic. For instance, during Muto's hearing in the Diet, DPJ policy makers criticized the BOJ's quantitative easing policy during which the bank purchased high amounts of government bonds. Somewhat inconsistent is that the DPJ itself proposed and supported this policy as a tool to fight deflation. Moreover, it was common knowledge that Yoshito Sengoku, former DPJ policy chief, was dead against Muto, but it was reported that Ozawa, the DPJ party leader, was willing to consent. As for Watanabe, Ozawa criticized his nomination as an act of *amakudari* (a golden parachute), while Hatoyama, the party's Secretary General, tended to accept him and candidly declared that he disagrees with Ozawa.[10]

A review of the literature demonstrates that independent central banks have been more successful in securing price stability than central banks dependent on national government or a finance ministry. Hence, the merit of an independent central bank is beyond question. On the other hand, is an insulation of monetary and fiscal policy at all times desirable? If both institutions act totally separate from each other, non-optimal policy mixes may emerge. Blinder describes scenarios of such non-optimal policy combinations.[11] For instance, the American Economy suffered a long time from the objectionable policy mix of tight money and loose fiscal policy in the Reagan-Volcker period.[12] Tobin adds that a "fiscal-monetary-tug-of-war" would cushion capital formation and growth. Consequently, coordination between both policies is preferable.[13]

Some economists are concerned about the BOJ's capital adequacy, since the bank purchased Japanese government bonds in a large extent to fight deflation. Financial strength is a crucial issue, since higher borrowing costs will create a capital loss for the Bank of Japan. The balance sheet can encumber a detriment to central bank operations. However, as Cargill points out, both the BOJ and the MOF need to cooperate to control balance sheet problems in order to shield the central banks main obligation of price stability. The BOJ and MOF must find out how to mutually and transparently ensure the BOJ's financial strength. In unusual situations, like deflation, when nontraditional

[10] Takashi Shiraishi (2008): Vacancies at BOJ, *Japan Echo*, Vol. 35, No. 3.
[11] Alan S. Blinder (2002): Commentary: Should the European Central Bank and the Federal Reserve Be Concerned about Fiscal Policy? *Rethinking Stabilization Policy*, A symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 29 – 31.
[12] Blinder suggests that this policy mix might be the natural Nash equilibrium of a non-cooperative game between the government and central bank.
[13] James Tobin (1982): Discussion, *Monetary Policy Issues in the 1980s*, A symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 9 – 10.

approaches and cooperation between both institutions become necessary, monetary and fiscal policy can not be viewed as totally separate from each other.[14]

According to former Bank of England policy maker Buiter, newly operationally independent central banks tend to avoid recommendations made by the Finance Ministry. They are concerned over loss of reputation if they do not act independently even if what they are being told by the Ministry make sense. Assuming that the Finance Minister gets it right from time to time, the central bank's response is not optimal. Central bank independence is perfectly consistent with communication and co-operation of politics when the situation requires it.[15] Put another way: "The point of central bank independence is to be able to refuse unreasonable or politically motivated government requests – the point of independence is not to refuse any and all requests."[16]

4. Different central banks – different monetary policy?

> "The textbook approach to monetary policy predominates over central bankers' differing personalities."[17]

A central bank's objective is to stabilize inflation rates and encourage long-term economic growth. Hence, how important is an independent and powerful central bank Governor to achieving these goals? Is a strong leader like former Fed Chairman Alan Greenspan a crucial factor, or is the appointment of an academic heavyweight like his successor Ben Bernanke a "better nostrum"? A recent empirical study investigated the effects of central bank gubernatorial appointments on financial markets. A dataset of 15 countries consisting of the announcement dates of central bank gubernatorial appointments was compiled with high-frequency data on exchange rates, bond yields, and stock prices. The findings suggest that financial markets react to appointments of new central bank Governors by means of foreign exchange markets, and to a lesser extent bond yields. Yet, the size markets shift expectations is generally rather small, and in many cases, particularly the stock exchange, insignificant.[18]

When confronted with economic shocks, modern central banks follow similar

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[14] Thomas F. Cargill (2006): Central Bank Capital, Financial Strength, and the Bank of Japan, *FRBSF Economic Letter*, No. 2006-11.
[15] Willem H. Buiter (2004): Two naked emperors? Concerns about the Stability & Growth Pact and second thoughts about central bank independence. London: LSE Research Online. http://eprints.Ise.ac.uk/archive/00000846.
[16] Adam S. Posen (2002): Deflation and the Bank of Japan, *The Japan Times*, February 9.
[17] Adam S. Posen (2007): Central Banking Dermatologists, *The International Economy*, Fall 2007, p. 11.
[18] Kenneth Kuttner and Adam S. Posen (2007): Do Markets Care Who Chairs the Central Bank? Working Paper Series, WP 07-3, *Peterson Institute for International Economics*.

monetary policy rules; there is not much variation between individual central bankers like Trichet, Bernanke, King, or Fukui. Differences in monetary policy implementation occur due to local financial structures and different economic forecasts and not because of individual personal style or ideology.[19] This position is supported by an ECB paper, which systematically compared the Eurosystem, the Fed and the BOJ with a simplistic policy reaction function framework and finds no noticeable distinctions in terms of monetary policy setting between the three central banks.[20] Additionally, according to Blinder and Morgan there is no significant difference if a Monetary Policy Committee has a strong leader or not.[21] Hence, it makes sense to analyze the rationale of the "keeping fiscal and monetary policy separate" argument in an international context.

5. International examples of MOF affiliated central bank leaders

> "The independence of central banks is under siege worldwide. Mr. Trichet deserves enormous credit for his unstinting toughness in resisting politically driven attempts to erode the integrity of his institution."[22]

This statement does not sound like it is addressed to a central banker, who backs down easily under political pressure. Before being appointed Bank of France Governor in 1993, Trichet had an abundant national and international career, including adviser to the President of the Republic. After acting as Deputy Director of bilateral affairs and head of international affairs at the French Treasury Department, he was promoted to head of the Treasury in 1987. According to Charles Wyplosz, an expert in monetary affairs, Trichet was not an advocate of low inflation, but rather demanded easy money from the central bank. After being appointed to central bank chief, he became a proponent of aggressive inflation fighting and tough central bank policies.[23]

In addition to Trichet, there are numerous examples of central bank chiefs who have arrived from the Ministry of Finance (**Figure 2**). With Duisenberg there is even a case of a former finance minister becoming central bank president. There is no evidence of inferior performance due to connections with the Ministry; in fact, they are highly respected as central bankers in financial circles. Paul Volcker, who had divided his

[19] Adam S. Posen (2007): Central Banking Dermatologists, *The International Economy*, Fall 2007.
[20] Dieter Gerdesmeier, Francesco Paolo Mongelli and Barbara Roffia (2007): The Eurosystem, the US Federal Reserve and the Bank of Japan – Similarities and Differences, *ECB Working Paper*, No. 742.
[21] Alan S. Blinder and John Morgan (2007): A Monetary Policy Experiment, *NBER Working Paper*, 13391.
[22] David Smick (2008), *The International Economy*, Winter 2008, p. 10.
[23] John Tagliabue (2003): French Verdict Will Resonate Throughout the Continent, *The New York Times*, June 17. http://query.nytimes.com/gst/fullpage.html?res=9506EED61538F934A25755C0A9659C8B63

career between government and the private sector, faced no less than 14 percent inflation by the time he was appointed as Federal Reserve Chairman in 1979. Using some unconventional policies, he managed to tame consumer prices down to four percent in 1987. The independence Volcker exercised in the face of extreme pressure from politicians brought him utmost praise among economists.

Figure 2: International examples of central bank leaders with MOF background

	Public Service	Highest position	Central bank leader
Jean-Claude Trichet	1971-1993	Director of the Treasury 1987-1993	1993-2003 Bank of France Since 2003 ECB
Willem F. Duisenberg	1973-1977	Finance Minister 1973-1977	1982-1997 The Dutch Bank 1998-2003 ECB
Hans Tietmeyer	1962-1989	Permanent Secretary 1982-1989	1993-1999 Bundesbank
Karl-Otto Pöhl	1970-1977	States Secretary 1973-1977	1980-1991 Bundesbank
Paul Volcker	1962-1965 1969-1974	Under Secretary for Monetary Affairs 1969-1974	1979-1987 Federal Reserve

One caveat is that Japan's financial system has so many idiosyncratic features that it is incomparable to other countries. But as Bloomberg reported, even DPJ leader Ozawa admits: "We are not opposed to finance ministry officials holding jobs at the central bank, as this is common in other countries as well […]".[24] Consequently, one cannot help but presume political motivations for the opposition's rejection strategy.

6. … and the national context

Analyzing the rationale behind the DPJ's argument in a national context, a recent study evaluated all BOJ chiefs since Tadashi Sasaki, to find no evidence that a Governor of BOJ origin performs better than a MOF-rooted Governor. In comparison with the predecessor, the real gross domestic product growth must be higher and the inflation rate more stable warrants a positive evaluation. According to this approach, Morinaga (MOF), Maekawa and Fukui (both BOJ) performed relatively well. On the other hand, among the Governors with rather unsatisfying performance were three from the BOJ (Sasaki, Mieno, and Hayami) and two from the MOF (Sumita and Matsushita). As a result, origin alone does not make a good Central Bank leader.[25] In other words, BOJ's top positions should be filled on basis of character, qualifications, and experience not

[24] http://www.bloomberg.com/apps/news?pid=20601101&sid=al26lt4b9TEs&refer=japan
[25] Yutaka Harada (2008): Does BoJ chief's origin affect results? *Nikkei Weekly,* March 31.

simply of background.

7. Masaaki Shirakawa – a fallback solution

Shirakawa’s expertise on monetary policy is highly regarded and most analysts consider him as well-suited for the Bank of Japan governor post, although some worry over his political skills. Jacob Frenkel, a former Bank of Israel Governor and Shirakawa’s teacher at Chicago University, put it a more blunt way, saying “Shirakawa wasn't a candidate of any political party. He doesn't owe anybody anything.”[26] Still, the best way to avoid political interference is to increase transparency. One of the first steps of the newly led BOJ was an announcement to increase the transparency in terms of its views over growth and inflation. The bank will extend the forecast horizon and publish a three-year growth and inflation forecast in its biannual outlook report – a salutary move that is highly welcomed by economists and central bank watchers.

Shirakawa is leading the BOJ in stormy economic times with Knightian uncertainty over inflation risks and economic growth.[27] The BOJ is walking a thin line as its monetary policy is almost running out of ammo, and the current developments in the economy are cutting the probability of a rate hike. On the other hand, Japan's benchmark interest rate is still at 0.5 percent, leaving little room for a maneuver to deal with the nation's lackluster growth rate.[28] Hence, one cannot expect wonders from the BOJ and its new Governor. Shirakawa’s litmus test will be the preparation of a rate-policy change.

An additional challenge is the two vacant posts on the Monetary Policy Board. The current seven member policy committee gives a rather unpleasant feeling, and Shirakawa and Deputy Governor Nishimura have repeatedly claimed to fill the vacancy as soon as possible. On the other hand, Blinder and Morgan find little support for the view that large groups outperform small groups in monetary policy setting.[29] Sibert supports this view and argues that the optimal size of a Monetary Policy Board is at least five members, but not much more.[30] Assuming that these findings are correct, the BOJ’s current seven member committee is no handicap for steering monetary policy.

[26] http://www.bloomberg.com/apps/news?pid=20601101&refer=japan&sid=aKDaZ6f00Tao
[27] Knightian uncertainty is named after the University of Chicago economist Frank Knight (1885-1972) and refers to risk that is impossible to calculate.
[28] According to Hiromichi Shirakawa (2008) of Credit Suisse Securities, the new governor is well suited and aware of the damaging effects of low interest rates. Lower rates are not likely to occur just because the short-range economic outlook is unpromising, *Ekonomikksu*, April, 22.
[29] Alan S. Blinder and John Morgan (2007): A Monetary Policy Experiment, *NBER Working Paper*, 13391.
[30] Anne Sibert (2006): Central Banking by Committee, *DNB Working Paper*, No. 91.

Shirakawa, due to his abundant experience at the Bank should navigate the depleted Monetary Policy Board in the right direction. Still, as a nine member Monetary Policy Board is maintained in BOJ law, the completion of the decimated Board should stand on elected officials' priority list. However, this author is afraid that Japanese legislators are highly ignorant as to the role of central banking and monetary policy. The political blame game among the two main parties is still causing irritation. If this issue was not so serious, one could appreciate politicians' sense of a brisk *jeu d`esprit*. Shirakawa came to the job by default, albeit notably a potential case of serendipity.

8. Conclusion

The leitmotif of rejecting former Finance Ministry officials in order to keep monetary policy separate from fiscal policy does not hold water. First, particular circumstances require cooperation on both policies. Second and more important, international examples demonstrate that whether or not a Central Bank Governor will act independently depends more on his personality than on his background. Furthermore, the opposition blocked a candidate who has no service at the MOF on his resume – a "reduction to the absurd".

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