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The Bubble Economy and the Bank of Japan*

*Ryunoshin KAMIKAWA***

ABSTRACT:

The main reason of the bubble economy of the late 1980's in Japan is generally thought to be the Bank of Japan's extremely low level of independence. Their explanation is that when the U.S. administration and the Ministry of Finance demanded that the Bank of Japan loosen monetary policy, the Bank complied, and that its loose monetary policy stimulated a rapid increase in the price of land and stocks. I argue, however, that the Bank of Japan ultimately decided to loosen monetary policy on its own volition, for the Bank worried excessively about a possible recession caused by the appreciation of the yen and was concerned about a sudden depreciation of the dollar. Moreover, there were no signs of an increase in inflationary pressures, though the value of assets continued to rise extraordinarily. Therefore, the Bank of Japan had no positive reasons to tighten monetary policy.

1. Introduction

In this article, I will examine the popular opinion that the dependent central bank caused the bubble economy in the late 1980's in Japan. I will argue that the Bank of Japan was independent from the prime minister and the Ministry of Finance to an extent that was important and that the Bank ultimately decided to loosen monetary policy on its own volition.

Most of the researchers regard the bubble economy of the late 1980's as a main cause of the stagnation of Japanese economy in the 1990's. Hiroshi Yoshikawa argues, for example, that the recession in the first half of the 1990's was caused by

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the stock adjustment and the reduction of investment as a reaction to the economic bubble; and the recession in the latter half of the 1990's was caused by the reduction of investment as a result of tighter bank lending and finance retrenchment policy[1]. Another cause that made the recession serious was the change of the bank behavior due to the increase of bad loans. Throughout the 1990's, according to the empirical analyses of economists, the drop of the property price caused by the collapse of the bubble economy deteriorated the balance sheets of enterprises and reduced the security price of their properties, which resulted in the credit crunch and decreased investment. They also argued that in the autumn of 1997 when concerns about the financial system deepened, the bad loan problem of banks that had continued for a long time decreased banks' capital. This intensified tighter bank lending, which meant the decline of the financial mediation function of banks[2].

Many economists, political scientists, and journalists insist that the Bank of Japan's extremely low level of independence was the main reason behind the inflation of the bubble economy. Their explanation goes as follows. The U.S. administration demanded that the Japanese government expand domestic demand to reduce its huge current account surplus with the U.S. However, the Ministry of Finance resisted increases in fiscal expenditures, instead prioritizing fiscal reconstruction. Thus, the Ministry demanded that the Bank of Japan loosen monetary policy. The Bank of Japan complied, unable to reject the Finance Ministry's demand due to its lack of independence from the Ministry. In February 1987, the Bank of Japan lowered the official discount rate to 2.5% and kept it at that level until May 1989. This excessively loose monetary policy drastically increased financial liquidity, stimulating a rapid increase in the price of land and stocks[3].

1) Hiroshi Yoshikawa, *Tenkan-ki no Nihon Keizai* [Turning Point of Japanese Economy] (Tokyo: Iwanami Shoten, 1999), pp.7-41.

2) Shigenori Shiratsuka, Hiroo Taguchi, and Naruki Mori, "Nihon ni okeru Baburu Hokai go no Chosei ni taisuru Seisaku Taio: Chukan Hokoku" [Policy Responses to the Post-Bubble Adjustments in Japan: A Tentative Review], *Kin-yu Kenkyu* 19, no.4 (2000): 87-143.

3) See, for example, William Grimes, *Unmaking the Japanese Miracle: Macroeconomic Politics, 1985-2000* (Ithaca: Cornell University Press, 2001); C. Randall Henning, *Currencies and Politics in the United States, Germany, and Japan* (Washington, D.C.: Institute for International Economics, 1994); Nobuhito Kishi, *Kenjin Tachi no Gosan* [Miscalculations by the Sages] (Tokyo: Nihon Keizai Shimbunsha, 1994), pp.41-89; Yoshihiro Kuroki, *Kin-yu Seisaku no Yukosei* [Effectiveness of Monetary Policy] (Tokyo: Toyo Keizai Shimposha, 1999), pp.177-205; Akira Sato, *Dokyumento Kin-yu Hatan* [Documentary of Financial Meltdown] (Tokyo: Iwanami Shoten), pp.326-363; Tsugio Tajiri, *Chuo Ginko Kiki no Jidai* [Age of Crisis for Central Banks] (Tokyo: Nihon Keizai Shimbunsha, 1997), pp.420-427.

In general, central bank's independence is judged by reference to the legal provisions concerning the relationship between the government and the central bank[4]. According to the former Bank of Japan Law, which was enacted in 1942, the Bank of Japan was placed under the supervision of the Finance Minister who had the power to order the Bank to undertake any necessary business. Moreover, the governor of the Bank of Japan was appointed by the cabinet and the cabinet had an authority to dismiss the governor. Therefore, the Bank of Japan had been regarded as a less independent central bank from the government and the Ministry of Finance before the Bank of Japan Law was revised to grant legal independence from the government in 1998[5]. To be sure, in 1973, inflation was aggravated because the Bank of Japan could not tighten monetary policy against Prime Minister Kakuei Tanaka who insisted on lowering interest rates[6].

However, in Japan, price stability has been achieved since 1975 though the central bank lacks formal independence[7]. Especially in 1980, the Bank of Japan tightened monetary policy against the Finance Ministry's wishes, and in doing so, succeeded in controlling inflation after the second oil shock[8]. In fact, Torben Iversen argues that the Bank of Japan has been implemented a conservative monetary policy since the late 1970's[9]. I insisted in another thesis that the Bank of Japan gained the substantial independence since 1975 and was able to decide monetary policy by itself to some extent against the pressures from the prime

4) Alberto Alesina and Lawrence H. Summers, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," *Journal of Money, Credit, and Banking* 25 (1993): 151-62; Alex Cukierman, Steven B. Webb, and Bilin Neyapti, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes," *The World Bank Economic Review* 6 (1992): 353-98; Vittorio Grilli, Donato Masciandaro, and Guido Tabellini, "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries," *Economic Policy* 13 (1991): 366-75.

5) Cukierman, Webb, and Neyapti, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes"; Grilli, Masciandaro, and Tabellini, "Political and Monetary Institutions and Public Financial Policies in the Industrial Countries"; Masaru Mabuchi, *Okurasho Tosei no Seiji Keizaigaku* [The Political Economy of the Treasury's Control] (Tokyo: Chuo Koronsha, 1994); Tajiri, *Chuo Ginko Kiki no Jidai.*

6) Thomas F. Cargill, Michael M. Hutchison, and Takatoshi Ito, *The Political Economy of Japanese Monetary Policy* (Cambridge: The MIT Press, 1997), pp.35, 191; Henning, *Currencies and Politics in the United States, Germany, and Japan*, pp.77-78.

7) Cargill, Hutchison, and Ito, *The Political Economy of Japanese Monetary Policy*, pp.5-6.

8) Ryunoshin Kamikawa, "Sengo Kin-yu Seisaku no Kettei" [The Politics of Monetary Policy in Postwar Japan], *Hogaku Ronso* 149, no.3 (2001): 97-117, 150, no.3 (2001): 103-27.

9) Torben Iversen, *Contested Economic Institutions: The Politics of Macroeconomics and Wage Bargaining in Advanced Democracies* (New York: Cambridge University Press, 1999), pp.57-60.

minister and the Ministry of Finance[10].

Then, in this article, I will examine the popular opinion that the dependent central bank caused the bubble economy in the late 1980's in Japan. I will argue that the Bank of Japan was independent from the prime minister and the Ministry of Finance to an extent that was important and that the Bank ultimately decided to loosen monetary policy on its own volition.

Now I argue how I evaluate the independence of the Bank of Japan. Sylvia Maxfield argues that

> Central bank authority is probably best evaluated by using classic indicators of power: number of instances in which a central bank achieves compliance with its policy preferences from those opposed and, more subtly, number of instances in which a central bank manages to keep opposing policy options off the policy agenda entirely[11].

Following her argument, I will examine the process of the Bank of Japan's loosening monetary policy and evaluate the independence of it.

If the Ministry of Finance demanded that it loosen monetary policy and it loosened monetary policy against its own policy preferences, I judged that it was not independent from the Ministry. However, if it agreed with the Ministry's demand and loosened monetary policy on its own will, I do not regard it as dependent. If it did not loosen monetary policy though the Ministry required to loosen monetary policy, I judge that it was independent from the Ministry.

This article is organized as follows. In the second section, I will argue that the loosened monetary policy did not trigger the asset price inflation but caused acceleration of it. That is, the asset price already began to rise in the early 1980's because of several factors other than the loosened monetary policy. In consequence, it was difficult for the Bank of Japan to judge that monetary policy should be tightened in order to control the asset prices. In the third and fourth section, I will trace the process through which monetary policy was formulated and demonstrate that the Bank of Japan was independent from the prime minister and the Ministry of Finance to some extent. In the fifth section, I will show that the Bank of Japan was not so dependent in comparison with the other central banks of the industrialized nations, especially with the German Bundesbank which was generally regarded as

10) Kamikawa, "Sengo Kin-yu Seisaku no Kettei."

11) Sylvia Maxfield, "Financial Incentives and Central Bank Authority in Industrializing Nations," *World Politics* 46, no.4 (1994): 556-88.

the most independent central bank.

2. The Rising of the Asset Prices in the early 1980's.

In this section, I will explain why the asset prices went up in the early 1980's.

Most economists insist that the excessive loosening of monetary policy caused the bubble economy. However, the asset price inflation in the late 1980's was not caused directly by loosening of monetary policy. The monetary easing is just one of necessary conditions for the bubble economy and it is never a sufficient condition. In my view, the bubble economy occurred because monetary policy was loosened when there was the upward tendency of stock and land prices already. In fact, in the early 1980's, though the economic condition was not so good, the prices of land and stocks were rising without loosened monetary policy. Why did the asset price go up in the early 1980's?

2.1. Surging Stock Prices

The stock prices in Japan began rising in 1983 and went up at a furious pace in 1986 and 1987. On October 20, 1987, stock prices dropped sharply because the New York Stock Exchange had collapsed on the preceding day. However, the Tokyo Stock Exchange recovered earlier than the stock exchange markets in other countries and the stock prices were skyrocketing until the end of 1989. Business boom started in 1987 and business had been sluggish before[12)]. Then, why the stock prices had risen before 1987?

At the end of the FY 1979, the prices of the 6.1 percent government bonds fell sharply and the loss of 13 city banks was estimated at about 550 billion yen. The Ministry of Finance gave notice that companies might change the accounting standard from lowest cost accounting to cost purchase accounting under which the value of the government bonds is estimated at the purchase price. By doing so, the Ministry of Finance thought that it was able to make banks buy the government bonds continuously because banks got off writing down. Then, a lot of banks adopted cost purchase accounting[13)]. However, owing to it, they had to write down by selling the government bonds unless the current prices of the government bonds

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12) Yasuhiro Yonezawa, *Kabushiki Shijo no Keizaigaku* [Economics of Stock Market] (Tokyo: Nihon Keizai Shimbunsha, 1995), pp.65-66.

13) Yasuharu Ishizawa, *Za MOF* [The Ministry of Finance] (Tokyo: Chuo Koronsha, 1995), pp.273-275.

were so expensive, because the average purchasing prices of the government bonds became expensive by adding up the prices of the 6.1 percent government bonds which were bought further and the government bonds which had been purchased already. Thus, in order to prompt companies and banks to purchase the government bonds, the Ministry of Finance permitted them to adopt the accounting procedure of dividing the book prices of securities which they had held already and those of securities which were bought by using cash in trust (so-called *Boka-Bunri*). Since companies could save the corporate income tax, most companies adopted this accounting procedure and corporate investment funds (specified money trust, so-called *Tokkin*) became a big thing. This gave rise to the boom of speculative investment on the stock exchange (*Zai-Tech* Boom)[14].

In Japan, banks and business corporations had held corporate stocks mutually and 70% of the total stocks were held as such cross-share holdings. That is, only 30% of the total stocks circulated in the stock exchange market. Thereby, aggregate market value went up much higher when speculative money flowed into the market[15].

Moreover, owing to the appreciation of land values, the stock prices of companies which had real estate increased. Securities companies reassessed the estate in land of business corporations and recommended to their customers that they purchase the stocks of the companies which had hidden profits on land[16].

In 1987, the stocks of NTT (Nippon Telegraph and Telephone Corporation) which had been privatized in 1985 were sold in order to cover the fiscal deficits. The Ministry of Finance persisted in selling the stocks of NTT at a high Price. Securities companies rigged the stock price of Tokyo Electric Power Company by recommending their customers purchasing the stocks. The Ministry of Finance gave silent approval to them. Tokyo Electric Power Company was regarded as a similar company to NTT because they were both occupied in public service, the government approved and licensed their rates, and their scales were similar. Hence, it was thought that the sales price of the NTT stock were determined in reference to the price of the Tokyo Electric Power Company stock. The advance of the Tokyo

14) Richard C. Hanson, *Okura Erito Hokori to Guko* [The Pride and Folly of Japan's Finance Ministry Elite] (Tokyo: TBS Buritanika, 1996), pp.87-89; Katsumi Kawano, *Kin-yu Jiyuka Senryaku no Kiketsu* [Consequence of Financial Liberalization Strategy] (Tokyo: Yuhikaku, 1995), pp.125-126; Ushio Shiota, 1993, *Okurasho no Fukaku* [Blunder of the Ministry of Finance] (Tokyo: Nihon Keizai Shimbunsha, 1993), pp.54-56.

15) Nihon Keizai Shimbunsha, *Kabu wa Shindaka* [Did Stocks Die?] (Tokyo: Nihon Keizai Shimbunsha, 1991), p.35.

16) Nihon Keizai Shimbunsha, *Kabu wa Shindaka*, p.84.

Electric Power Company stock led to an increase of the sales price of the NTT stock easily. In November 1986, the initial public offering price of the NTT stock was determined at 1,197,000 yen. As a matter of fact, the research departments of most securities companies had written reports that 700 or 800 thousands yen was a reasonable price of it. Yet, the Ministry of Finance prevented them from publishing their reports[17)]. After that, the price of it continued to improve and speculative investment on the stock exchange became very popular in Japan.

On October 19, 1987, the New York Stock Exchange collapsed. On the following day, the stock price dropped in the Tokyo Stock Exchange likewise. The executives of both the Securities Bureau of the Ministry of Finance and the major four securities companies had a regular meeting on that day. They decided that the fixed limit of proprietary trading would be eased and securities companies would prop up share prices by tacit agreement. Also, the securities companies arranged for themselves not to send selling orders to the stock market[18)]. Securities companies sold stocks to amateur investors on a large scale[19)]. Moreover, the Ministry of Finance pressed investment companies to purchase shares[20)]. Hereby, stock prices rallied.

The Ministry of Finance had to keep the stock prices in order not only to head off a worldwide recession but also to keep the NTT stock at a higher price. It would be on November 20 that the second tranche of the sales of the NTT stocks would be taken place. In fact, the Ministry of Finance tried to keep the price of the NTT stock by calling on institutional investors not to sell the NTT stocks[21)]. In the end, the NTT stocks sold for 2,250,000 yen and the government got about 5 trillion yen[22)].

At the end of December 1987, life insurance companies started to sell stocks in bulk in order to cover the loss of dollar earnings and corporate investment funds. In April 1987, the Banking Bureau of the Ministry of Finance already instructed firms to change the accounting standard from cost purchase accounting to lower cost accounting next March. The Securities Bureau of the Ministry of Finance worried about sell-off of shares. It asked the Banking Bureau for changing the accounting

17) Takao Saito, *Kuni ga Damashita* [The Government Deceived] (Tokyo: Bungei Shunju, 1993), pp.83-94.

18) Shiota, *Okurasho no Fukaku*, pp.38-48; Takashi Tachibana, *Dojidai wo Utsu* [Criticizing the Contemporary Affairs] (Tokyo: Kodansha, 1988), p.268.

19) Tachibana, *Dojidai wo Utsu*, pp.263-268.

20) Ibid., pp.269-274.

21) Juzo Arihara, *Okurasho Yuragu Soshiki to Seisaku* [The Ministry of Finance: Its Institution and Policy Waver] (Tokyo: San-ichi Shobo, 1996), pp.108-109.

22) Shiota, *Okurasho no Fukaku*, pp.150-160; Tachibana, *Dojidai wo Utsu*, pp.287-292.

standard again. Therefore, the Banking Bureau instructed firms to postpone the introduction of lower cost accounting until April 1. Because of this instruction, companies did not need to write down and life insurance companies did not have to sell stocks by the gross[23)].

These measures taken by the Ministry of Finance got acclaim in the United States and Europe in those days because they contributed to heading off a worldwide recession[24)]. However, they made the markets believe that the Ministry of Finance never would let stock prices drop, which caused stock prices to surge after that.

2.2. Surging Land Prices

The skyrocketing land prices in 1980's started from areas around Tokyo. Since 1982, the land prices of business districts in Tokyo had shot up. After that, soaring land prices spread to residential districts in Tokyo. In the late 1980's, land prices skyrocketed all over the country at last[25)]. Why did the land prices of business districts in Tokyo rise sharply in the early 1980's?

In the early 1980's, foreign financial institutions expanded into Tokyo owing to financial internationalization and financial deregulation in Japan. This caused the lack of office buildings in Tokyo. In the first place, the business activities in Japan concentrated in Tokyo and the rate of operation of offices there had exceeded 100% already[26)].

In addition, it had an impact on land prices that Prime Minister Yasuhiro Nakasone started urban renewal (so-called *Urban Renaissance*). The Nakasone Administration deregulated land utilization and building standards, disposed of state-owned land, and advanced large-scale development projects in the urban area[27)]. In May 1985, the National Land Agency published "The Capital Reform Project" and announced the overly-inflated demand forecast of office buildings in

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23) Arihara, *Okurasho Yuragu Soshiki to Seisaku*, p.112; Hanson, *Okura Erito Hokori to Guko*, pp.107-117; Ishizawa, *Za MOF*, pp.276-278; Shiota, *Okurasho no Fukaku*, pp.49-61.

24) Hanson, *Okura Erito Hokori to Guko*, pp.117-118.

25) Yukio Noguchi, *Tochi no Keizaigkau* [Economics of Land] (Tokyo: Nihon Keizai Shimbunsha, 1989), pp.52-54.

26) Nihon Ginko (Bank of Japan), "Waga Kuni ni okeru Kin-nen no Chika Josho no Haikei to Eikyo ni tsuite" [About the Background and Influence of Surging Land Prices Recently in Our Country], *Chosa Geppo*, April, 1990: 34-85.

27) Hideo Otake, *Jiyushugi teki Kaikaku no Jidai* [The Era of Liberal Reforms] (Tokyo: Chuo Koronsha, 1994), pp.189-211.

Tokyo[28)]. These brought on surge in land prices of business districts there.

This soaring land prices in commercial districts spread to residential districts because people who had sold their lands for constructing office buildings got land for living[29)]. Then, real estate speculation intensified and contributed to further rises in land prices[30)].

The land prices in Japan tended to rise easily because of both the land tax system which hindered effective utilization of land[31)] and the myth of ever-higher land prices (*Tochi Shinwa*)[32)]. In this situation, it had so decisive influence on surge in land prices that banks increased real estate loans rapidly. Because financial deregulation had large companies obtain financing from the market, banks became unable to lend money to them and increased real estate loans instead[33)].

Masaru Yoshitomi argued that not monetary ease by the Bank of Japan but the run-up in asset prices caused excess liquidity[34)]. That is, soaring asset prices enabled asset holders to borrow money on security of their assets. They bought land and stocks additionally with the money and asset prices rose further. Thus, both financial assets and financial liabilities increased in a spiral[35)].

Low interest rates were not responsible for the advent of asset inflation but for the expansion of the bubble economy by reducing the cost of speculation. Surge in land prices and stock prices had different reasons and reflected actual demand partially. Hence, it was difficult for the Bank of Japan to regard monetary easing as the main cause of soaring asset prices. Therefore, it was hard for the Bank of Japan to become aware that it should tighten monetary policy in order to drive down the asset prices.

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28) Kishi, *Kenjin Tachi no Gosan*, pp.169-193; Nihon Keizai Shimbunsha, *Han-i naki Ayamachi* [Mistake without Malice] (Tokyo: Nihon Keizai Shimbunsha, 2000), pp.40-44; Soichiro Tahara, *Heisei Nihon no Kanryo* [Bureaucracy in Japan in Heisei Era] (Tokyo: Bungei Shunju), pp.201-224.

29) Kawano, *Kin-yu Jiyuka Senryaku no Kiketsu*, p.72; Noguchi, *Tochi no Keizaigkau*, p.54.

30) Noguchi, *Tochi no Keizaigkau*, p.55.

31) Ibid., pp.129-174.

32) Kawano, *Kin-yu Jiyuka Senryaku no Kiketsu*, pp.73-74.

33) Koetsu Aizawa, *Nichigin-Ho Nijugo-Jo Hatsudo* [Exercising the Article 25 of the Bank of Japan Law] (Tokyo: Chuo Koronsha, 1995), pp.129-136; Yoshikawa, *Tenkan-ki no Nihon Keizai*, pp.61-62.

34) Masaru Yoshitomi, *Nihon Keizai no Shinjitsu* [Truth about Japanese Economy] (Tokyo: Toyo Keizai Shimposha, 1998), pp.52-96.

35) Yoshikazu Miyazaki, *Kokumin Keizai no Tasogare* [National Economy in the Twilight] (Tokyo: Asahi Shimbunsha, 1995), p.163; Nihon Keizai Shimbunsha, *Kabu wa Shindaka*, p.85.

3. Monetary Policymaking Process from the Plaza Accord to Black Monday

In this section, I will show the process through which monetary policy was formulated from the Plaza Accord in September 1985 to Black Monday in October 1987. The Bank of Japan lowered its official discount rate five times; in January 1986, March 1986, April 1986, November 1986, and February 1987. Akira Sato, a journalist who interviewed people involved in monetary policy making, states that the two decisions of lowering the official discount rate in November 1986 and February 1987 were taken without discussions within the Bank of Japan[36]. These two decisions were reputed to be wrong from the viewpoint of preventing the bubble economy[37]. I will examine whether the Bank of Japan made these decisions autonomously or the Ministry of Finance forced the Bank of Japan to make these decisions.

The Reagan's first Administration adopted strong dollar policy. This policy weakened the international competitiveness of manufacturing industry. The Congress conservatized because industrial circles lobbied hard for protectionism[38]. Moreover, since the U.S. became a net debtor nation, it was believed that the deficit in the current account would cause outflow of foreign capital and that the economic condition would worsen by rising in interest rates[39]. Therefore, the Reagan's second Administration changed this policy.

In September 1985, the Plaza Accord was reached in which G5 countries agreed to appreciate non-dollar currencies against the dollar by joint interventions. Japan accepted a stronger yen in a positive way. Prime Minister Yasuhiro Nakasone had aspired to "strong yen" previously[40] and Finance Minister Noboru Takeshita who

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36) Sato, *Dokyumento Kin-yu Hatan*, p.335.

37) See, for example, Toshihiko Yoshino, "Sengo no Nichigin Sosai wa Nani wo Nashita ka" [What did the Governors of Bank of Japan after the Second World War Achieve?], *Ekonomisuto*, December 26, 1989: 50-54.

38) I. M. Destler and C. Randall Henning, *Dollar Politics: Exchange Rate Policymaking in the United States* (Washington, D.C.: Institute for International Economics, 1989), pp.33-41; Yoichi Funabashi, *Tsuka Retsuretsu* (Tokyo: Asahi Shimbunsha, 1988), pp.98-106 [English version, Yoichi Funabashi, *Managing the Dollar: From the Plaza to the Louvre* (Washington, D.C.: Institute for International Economics, 1988)]; NHK Shuzai-Han, "Puraza Goi" [Plaza Accord]. In *Sono Toki Nihon wa: Dai 6 Kan* [Japan at that time, vol.6] (Tokyo: NHK, 1996) pp.17-21.

39) Naoko Ishii, *Seisaku Kyocho no Keizaigaku* [Economics of Policy Coordination] (Tokyo: Nihon Keizai Shimbunsha, 1990), pp.25-31; Heizo Takenaka, *Nichi-bei Masatsu no Keizaigaku* [Economics of Conflict between Japan and the U.S.] (Tokyo: Nihon Keizai Shimbunsha, 1991), pp.86-92.

40) Funabashi, *Tsuka Retsuretsu*, pp.123-127.

aimed for becoming next prime minister wanted to show a great diplomatic achievement[41].

The value of the dollar did not decline to a large extent immediately in spite of the joint interventions and verbal interventions. However, the Bank of Japan had induced higher short-term interest rates since October 24, which triggered the sharp appreciation of the yen against the dollar. The Bank of Japan took strong yen policy positively because it had not been able to implement monetary policy flexibly due to a depreciation of the yen and appreciating yen contributed to price stability. Expecting Japan to expand its domestic demand, the U.S. blamed it for a rising of short-term interest rates. The Ministry of Finance complained about raising them to the Bank of Japan likewise. The Bank of Japan insisted that increasing short-term interest rates helped to raise the value of yen and continued to implement this policy until the end of the year[42].

Within the Bank of Japan, there were two factions of executives. One faction which was called "*Kokunai-Ha*" consisted of executives who specialized in domestic affairs. They thought that domestic economy was more important than international economy, stabilizing prices was the mission of the Bank of Japan, and keeping independence of the Bank of Japan from the government was very important in order to stabilize prices. The other faction which was called "*Kokusai-Ha*" consisted of executives who specialized in international affairs. They thought that Japan had to contribute to the growth of international economy as much as possible and implement monetary policy from the internationally cooperative standpoint.

"*Kokunai-Ha*" took initiative for this rising of short-term interest rates in October 1985[43]. They were afraid that the Bank of Japan might be hampered from implementing monetary policy autonomously on the ground of international coordination. They demonstrated that raising interest rates triggered a rise of the yen against the dollar.

After that, yen became stronger and stronger. However, trade deficit of the U.S. continued to rise and the Reagan Administration stepped up demands for Japan and West Germany to expand domestic demand. Prime Minister Nakasone remarked

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41) Ibid., pp.133-134.

42) Ibid., pp.50-51, p.155; Hitoshi Noguchi, *Nichi-bei Tsuka Kosho 2000 Nichi* [Negotiations on Currency between Japan and the U.S. for 2000 days] (Tokyo: Nihon Keizai Shimbunsha, 1995), pp.72-77; Ushio Shiota, *Okurasho vs. Amerika* [The Ministry of Finance vs. the U.S.] (Tokyo: Kodansha, 1994), pp.329-336.

43) Funabashi, *Tsuka Retsuretsu*, p.155; Noguchi, *Nichi-bei Tsuka Kosho 2000 Nichi* , pp.72-77.

that industrialized nations should implement coordinated cuts in interest rates on December 18, 1985. Finance Minister Takeshita expressed readiness to accept a stronger yen. Takeshita and the Ministry of Finance expected that the Bank of Japan cut its official discount rate if the yen got stronger, for strong yen stabilized prices. Both Nakasone and Takeshita wanted the official discount rate to be lowered in order to meet the U.S. demand to expand domestic demand[44].

Governor of the Bank of Japan Satoshi Sumita, who had served as Administrative Vice-Minister of Finance, explored opportunities to cut its official discount rate in order to expand domestic demand at that time, but he cared that lowering of interest rates only in Japan, not coordinated cuts in interest rates, would trigger a rise of the dollar. However, since verbal intervention of Takeshita gave rise to a further rise of the yen, the Bank of Japan cut its official discount rate from 5% to 4.5% a year on January 30, 1986. Furthermore, Japan, the U.S., and West Germany implemented coordinated cuts in interest rates in March and the official discount rate of the Bank of Japan became 4%. The Bundesbank acceded to coordinated cuts in interest rates because inflationary pressure got weaker by reason of dropping oil prices[45].

Though coordinated cuts in interest rates were implemented in March, business was weakening in the U.S. owing to decline in oil prices. The Reagan Administration began to put pressure upon the Federal Reserve Board in demand for additional money-easing. Actually, in February 1986, the directors who were appointed by President Reagan overruled Chairman Paul Volcker and voted a discount rate cut. This is known as the "palace coup." Volcker compromised with them on condition that the cut was deferred to give him time to negotiate a coordinated reduction with the Bundesbank and the Bank of Japan[46]. He suspected that lowering of interest rate only in the U.S. would trigger collapse of the dollar.

In April, Secretary of the Treasury James Baker required lowering of interest rates of Takeshita. Volcker called on Sumita for it likewise. In Japan at that time, the mass media criticized the government for its lack of policy to excessively strong yen because of sharp appreciation of the yen amid growing concerns over economic slump. The policy to raise the yen had been abandoned and the Bank of Japan had already intervened in the foreign exchange market by selling yen independently on

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44) Noguchi, *Nichi-bei Tsuka Kosho 2000 Nichi* , pp.83-91; Shiota, *Okurasho vs. Amerika*, pp.337-346.

45) Funabashi, *Tsuka Retsuretsu*, pp.63-67.

46) Ibid., pp.67-70; Henning, *Currencies and Politics in the United States, Germany, and Japan*, p.284.

March 19[47]. Therefore, Takeshita and Sumita viewed these demands as a godsend and accepted them[48]. However, Sumita made promises without conferring with the executives of the Bank of Japan. "*Kokunai-Ha*" in the Bank of Japan began to entertain antipathy toward the U.S. as it forced Japan to reduce interest rates. However, Governor Sumita having promised the U.S. rate reduction already, the U.S. and Japan implemented coordinated cuts in interest rates on April 21 and the official discount rate of the Bank of Japan became 3.5%[49].

Prime Minister Nakasone found himself in serious straits with House of Councilors election around the corner as the yen continued to appreciate. Secretary Baker remarked that high dollar rate was corrected sufficiently on May 13 and 20 in order to help Nakasone though he had continued to say that the strong dollar was not corrected adequately in order to let the dollar fall in value[50]. Then, Baker demanded additional money-easing. However, the Bank of Japan rejected this demand on the grounds of House of Councilors election. The Ministry of Finance called for the Bank of Japan to lower interest rates and tried to make it cut interest rates by stopping supplying funding to intervene in the foreign exchange market and accepting a stronger yen (in Japan, the Ministry of Finance had the authority to decide to intervene in the foreign exchange market and the Bank of Japan put it into execution as the Bank received the Finance Ministry's instructions). Nevertheless, the Bank of Japan rejected this demand to the last[51].

On July 6, the double election (House of Representatives election and House of Councilors election) was held and the Liberal Democratic Party (LDP) won an overwhelming victory. Nakasone formed a cabinet on July 22. Takeshita was appointed as the LDP Secretary-General and Kiichi Miyazawa was appointed as Finance Minister.

On September 6, in talk with Finance Minister Miyazawa, Secretary Baker demanded lowering of interest rate and expanding government spending by compiling a supplementary budget. At that time, the LDP politicians began to request formation of supplementary budget to deal with the appreciation of the yen. Prime Minister Nakasone who had been committed to fiscal reconstruction admitted their claims. On September 16, the government announced the

47) Noguchi, *Nichi-bei Tsuka Kosho 2000 Nichi*, pp.101-105.

48) Funabashi, *Tsuka Retsuretsu*, pp.70-71.

49) Makoto Sataka, "Okurasho vs. Nichigin no Anto" [The Secret Strife between the Ministry of Finance and the Bank of Japan], *Bungei Shunju*, October 1986: 110-120. See also, Grimes, *Unmaking the Japanese Miracle*, p.117; NHK Shuzai-Han, "Puraza Goi," pp.115-118.

50) Funabashi, *Tsuka Retsuretsu*, pp.225-226; NHK Shuzai-Han, "Puraza Goi," pp.111-114.

51) Funabashi, *Tsuka Retsuretsu*, pp.72-73.

Comprehensive Economic Measure which included compilation of a supplementary budget worth 3.6 trillion. However, it was nothing but a patchwork of various estimated costs and the total amount of the actual increase of government spending, so-called "real money" was only 130 billions[52]. The Ministry of Finance tried to avoid issuance of deficit-covering bonds at any cost. However, the Ministry of Finance could not help issuing them in the end.

In the end of September, G5 and G7 were held in Washington, D.C. and Finance Minister Miyazawa and Secretary Baker had a meeting. Though Baker appreciated the formation of supplementary budget, he demanded lowering of interest rates. Miyazawa and Volcker requested Governor Sumita to cut interest rates and Sumita implied rate reduction in a press conference on October 1[53].

However, on October 3, Vice-Governor of the Bank of Japan Yasushi Mieno, who was the leader of "*Kokunai-Ha*" and regarded as the next governor, denied the possibility of rate reduction with clarity in a statement at the Diet[54]. Michio Fukai, who served as an Executive Director of the Bank of Japan at that time, tells that "*Kokunai-Ha*" and "*Kokusai-Ha*" joined issue on rate reduction. "*Kokunai-Ha*" insisted that monetary policy should be managed in line with the current conditions of the Japanese economy and that lowering of interest rates was not necessary because of the sharp rise of money supply and asset prices. On the other hand, "*Kokusai-Ha*" insisted that monetary policy should be managed in concert with the U.S[55]. They did not reach the agreement on this issue and interest rates were left unchanged. Then, Yoshihiko Yoshino, Administrative Vice-Minister of Finance, instructed by Finance Minister Miyazawa, told Vice-Governor Mieno that Governor Sumita had promised Miyazawa lowering of the official discount rate and asked Mieno when the rate reduction would be implemented[56]. As Mieno heard that Sumita had promised Miyazawa lowering of interest rates, he thought that he had no alternative but to agree to lower the official discount rate. On October 31, the Bank of Japan decided to cut it to 3%, which was implemented on November 1. Miyazawa and Baker released a joint statement which contained exchange rate stability on the same day.

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52) Ibid., p.238; NHK Shuzai-Han, "Puraza Goi," pp.124-126; Shiota, *Okurasho vs. Amerika*, p.387.

53) Funabashi, *Tsuka Retsuretsu*, pp.77-79; NHK Shuzai-Han, "Puraza Goi," pp.128-129; Noguchi, *Nichi-bei Tsuka Kosho 2000 Nichi*, pp.132-135.

54) NHK Shuzai-Han, "Puraza Goi," pp.127-128; Noguchi, *Nichi-bei Tsuka Kosho 2000 Nichi*, p.135.

55) Sato, *Dokyumento Kin-yu Hatan*, pp.340-341.

56) Funabashi, *Tsuka Retsuretsu*, p.79.

The rise of the yen stopped temporarily thanks to this statement. Though Miyazawa made a demand for expanding government spending on budget for the FY 1989, Administrative Vice-Minister Yoshino resisted this doggedly and austere budget policy was maintained[57]. Baker perceived that government spending in Japan was not expanded sufficiently and began to talk down the dollar. The yen appreciated sharply against the dollar again. Miyazawa went to the U.S. and negotiated with Baker to stop the rapid appreciation of the yen on January 21, 1987. Miyazawa used interest-rate cut to get Baker to cooperate for exchange rate stability[58]. Yet, the outside investors were disaffected to the U.S. weak dollar policy. They came to be reluctant to invest in the U.S. market and interest rates started to rise[59]. The U.S. needed to attract foreign investment in order to make up for the enormous fiscal deficit. Therefore, it was about time that the U.S. stabilized exchange rates.

On February 20, 1987, the Bank of Japan decided to cut its official discount rate to a record low of 2.5%, which was implemented on February 23. Sumita said in a press conference that this rate reduction was near to the limit and implied that expanding government spending was required in order to expand domestic demand and stabilize exchange rate[60]. Yoshio Suzuki, who served as Director-General of Institute for Monetary and Economic Studies, Bank of Japan at that time, states that Miyazawa and Sumita had decided to lower the official discount rate and the executives of the Bank including Suzuki were able to do nothing about it[61]. On February 22, G6 Finance Ministers and Central Bank Governors agreed to cooperate closely to foster stability of exchange rates around current levels (the Louvres Accord).

However, the yen continued to appreciate against the dollar and the U.S. trade deficit with Japan was not diminished. On April 8, FRB Chairman Volcker requested Governor Sumita to lower the official discount rate, but Sumita declined. Though the U.S., Finance Minister Miyazawa, and the Ministry of Finance continued to demand rate reduction of the Bank of Japan with insistence, the Bank continued to refuse[62].

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57) Noguchi, *Nichi-bei Tsuka Kosho 2000 Nichi*, pp.140-141; Shiota, *Okurasho vs. Amerika*, pp.387-390.

58) NHK Shuzai-Han, "Puraza Goi," p.135.

59) Ibid., p.137.

60) *Asahi Shimbun*, February 21, 1987.

61) Kishi, *Kenjin Tachi no Gosan*, p.43.

62) NHK Shuzai-Han, "Puraza Goi," p.143; Noguchi, *Nichi-bei Tsuka Kosho 2000 Nichi*, pp.172-173.

Miyazawa had promised Baker to increase public spending on economic pump-priming measures. Nakasone realized that expanding government spending was necessary in order to stop the rise of the yen. LDP politicians voiced a strong desire to expand it. The government decided for compiling a supplementary budget worth 6 trillion on May 29, 1987[63]. However, the Japanese economy began to recover from the beginning of 1987. Thus, it is said that this expanding fiscal expenditure was overabundant and overheated economy[64].

Vice-Governor of the Bank of Japan Mieno was cautious about inflation and warned that it was as if Japanese economy was sitting on dry firewood. In summer 1987, the executives of the Bank of Japan began to lay the groundwork for the decision of raising its official discount rate. They stressed the risk of increasing inflationary pressure[65]. The Bank guided the short-term interest rates higher in the market from the end of August[66].

In the U.S., on the other hand, the new FRB Chairman Alan Greenspan raised interest rates in September. However, the dollar depreciated. Then, the U.S. government requested Japan and West Germany to reduce interest rates. Both countries declined and the Bundesbank performed an operation for increasing in the short-term interest rates in the market. Secretary Baker resented this and stated that the U.S. tolerated a weaker dollar on October 16. Investors recognized that this statement meant the failure of international policy coordination and they moved their financial assets out of the U.S. for fear of collapse of the dollar. This caused the heavy fall in the New York Stock Exchange on October 19 (Black Monday)[67]. The depreciation of the dollar continued after that and inflated asset prices and bond prices collapsed in the U.S. Then, Secretary Baker persuaded West Germany to lower the short-term interest rates[68].

Governor Sumita decided to stop guiding the short-term interest rates higher[69]. The Ministry of Finance blamed the Bank of Japan for Black Monday. The

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63) Funabashi 1988, pp.142-150; Kishi, *Kenjin Tachi no Gosan*, pp.15-40; NHK Shuzai-Han, "Puraza Goi," pp.145-154.

64) Arihara, *Okurasho Yuragu Soshiki to Seisaku*, p.88.

65) Masayoshi Mizuno, *Nichigin Himerareta "Hanran"* [Bank of Japan: Hidden Revolt] (Tokyo: Jiji Tsushinsha, 1997), p.169.

66) Kunio Okina, Masaaki Shirakawa, and Shigenori Shiratsuka, "Shisan Kakaku Baburu to Kin-yu Seisaku" [The Asset Price Bubble and Monetary Policy], *Kin-yu Kenkyu* 19, vol.4 (2000): 261-322.

67) NHK Shuzai-Han, "Puraza Goi," pp.158-160.

68) Noguchi, *Nichi-bei Tsuka Kosho 2000 Nichi*, pp.201-205.

69) Nihon Keizai Shimbunsha, *Han-i naki Ayamachi*, p.33.

executives of the Ministry said that Vice-Governor Mieno who was ignorant about international economy gave rise to confusion by emphasizing the alarm over inflation[70]. This crash in stock prices deprived the Bank of Japan of the opportunity to raise its official discount rate.

Hereinafter, I will examine whether the Bank of Japan from the Plaza Accord to Black Monday was subject to the Ministry of Finance or not. Within the Bank of Japan, it was commonly said that the Bank itself decided to reduce its official discount rate in January 1986, March 1986, and April 1986, yet Finance Minister Miyazawa colluding with Governor Sumita decided to reduce its rate in November 1986 and February 1987[71]. Yoshio Suzuki tells that seeking the advice of Vice-Governor Mieno, Governor Sumita decided to reduce its rate from January 1986 to April 1986, but that he decided to reduce its rate in November 1986 and February 1987 without debate[72]. Was Governor Sumita forced to reduce its rate by Finance Minister Miyazawa? Did he accept Miyazawa's requests against his own will?

However, these rate reductions were not necessarily unreasonable. When home currency surges, it is common for the country to loosen monetary policy in order to deal with the deflationary effect. Even the Bundesbank which was regarded as the most independent central bank loosened monetary policy from 1975 to 1978 and from 1986 to 1988 when the mark soared against the dollar[73].

An possible objection against this argument will be that the Bank of Japan lowered its official discount rate five times, yet the Bundesbank lowered its rate only twice after the Plaza Accord, and that this fact is the evidence that the Bank of Japan was much less independent than the Bundesbank.

However, I can counter this objection. First, it was not West Germany but Japan that was borne the brunt of attack by the U.S. Congress owing to its large trade surplus with the U.S.[74] It was natural that the U.S. put greater pressure on Japan to loosen monetary policy than on West Germany. Second, and more critically, the degree of dependence on trade with the U.S. of Japan was higher than that of West Germany[75] and the ratio of export in terms of dollar of Japan was much higher than

70) Mizuno, *Nichigin Himerareta "Hanran,"* p.169.

71) Sato, *Dokyumento Kin-yu Hatan*, p.335.

72) Ushio Shiota ed. *Kinri wo Ugokasu Otokotachi* [Men Operating Interest Rates] (Tokyo: Kanki Shuppan, 1992), pp.38-39.

73) Ben Bernanke and Frederic Mishkin, "Central Bank Behavior and the Strategy of Monetary Policy: Observation from Six Industrial Countries." In *NBER Macroeconomics Annual* (Cambridge: The MIT Press, 1992), pp.183-228.

74) Funabashi, *Tsuka Retsuretsu*, p.157; NHK Shuzai-Han, "Puraza Goi," pp.17-18.

75) Yoshiko Kojo, *Keizaiteki Sogo Izon to Kokka* [Economic Interdependence and State] (Tokyo:

that of West Germany[76]. Thus, export industries in Japan suffered more serious damage than those in West Germany from the depreciation of the dollar. Therefore, the Bank of Japan gave more serious consideration to negative effect of the weak dollar on the economy than the Bundesbank did.

Nonetheless, it was true that there was a conflict between the Bank of Japan and the Ministry of Finance over managing monetary policy. Hence, I examine two cases in November 1986 and in February 1987, which are said that the Ministry forced the Bank to reduce the official discount rate. On October 1, 1986, Governor Sumita who was requested to lower the official discount rate implied rate reduction. However, "*Kokunai-Ha*" including Vice-Governor Mieno strongly opposed it and the decision was delayed. In the end, Mieno approved it in the end of October because he was informed that Governor Sumita had promised it to Finance Minister Miyazawa. In February 1987, Governor Sumita determined to accept Miyazawa's request for lowering the official discount rate on his own judgment without consulting Vice-Governor Mieno. Governor Sumita decided these rate reductions against the will of "*Kokunai-Ha*" within the Bank.

The reason why Governor Sumita decided these rate reductions was not that Finance Minister Miyazawa, the Ministry of Finance, and the U.S. forced him to do them, for he was a former Administrative Vice-Minister of Finance and regarded as a man of influence. Moreover, he was a senior bureaucrat of Miyazawa in the Ministry of Finance[77]. His determinations to reduce the official discount rate were based on his appreciation of the economical situation. That is, he determined them to stop the sharp appreciation of the yen, attaching great importance to deflationary effect of the strong yen.

On the contrary, "*Kokunai-Ha*" opposed monetary easing because it expected that excessively easy monetary policy would cause inflation and was worried that the independence of the Bank of Japan would be undermined if the Bank of Japan would accept the U.S. demand for monetary easing. On the other hand, "*Kokusai-Ha*" within the Bank agreed to lower the official discount rate since it gave priority to international policy coordination.

The Bank of Japan Law at the time gave the Policy Board final responsibility for monetary policy operation of the Bank. However, the Policy Board had lapsed into the practice of following the recommendations made by the executive board of

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Bokutakusha, 1996), pp.165-166.

76) Yoshikazu Miyazaki, *Doru to En* [Dollar and Yen] (Tokyo: Iwanami Shoten, 1988), p.130.

77) Funabashi, *Tsuka Retsuretsu*, p.80.

directors representing several departments within the Bank[78]. In addition, articles of the Bank of Japan prescribed governor's control over the executive board of directors. Therefore, Governor Sumita was able to make policy decisions from the top-down. In addition, "*Kokusai-Ha*" endorsed his decisions.

In many cases, the Bank of Japan resisted pressures from the Ministry of Finance, Finance Minister, and the U.S. First, in spite of the opposition of the Ministry of Finance and the U.S., the Bank continued to guide the short-term interest rates higher from fall 1985 to the end of the year. Second, the Bank rejected the demands for rate reduction from the U.S. and the Ministry in May and June 1986. The Ministry tried to make the Bank lower its official discount rate by stopping supplying funding to intervene in the foreign exchange market, but the Bank did not obey the Ministry. Third, the Bank had refused the Ministry and the U.S. demands for lowering the official discount rate since April 1987. In February 1987, Governor Sumita proposed to the government that the appreciation of the yen should be dealt with not by monetary policy but by fiscal policy from then.

These cases show that the Ministry of Finance did not have means of forcing the Bank of Japan to implement monetary policy which the Ministry wished and the Bank of Japan was able to implement the policy which it would like. The former Bank of Japan Law gave the Ministry of Finance the authority for supervising the Bank of Japan and ordering it to undertake any necessary business. Yet, in practice, these powers were not carried out in the policy making.

4. Why Had Not the Official Discount Rate Been Raised for 2 Years and 3 Months?

In February 1987, the Bank of Japan lowered its official discount rate to 2.5% and kept the rate at that level until May 1989. It is said that this excessively loose monetary policy drastically increased financial liquidity, stimulating a rapid increase in the prices of land and stocks. In previous section, I explained that Black Monday deprived the Bank of Japan of the opportunity to raise the rate. However, stocks in Tokyo bounced back early by the Finance Ministry's measures to bolster stock market prices and stock prices soared in 1988. Why did not the Bank of Japan raise the rate in 1988?

It is the widely-accepted explanation that the Bank of Japan was forced not to

78) Thomas F. Cargill, Michael M. Hutchison, and Takatoshi Ito, *Financial Policy and Central Banking in Japan* (Cambridge: The MIT Press, 2000), p.89.

raise the rate by political pressures. Yoshio Suzuki, who served as an Executive Directors of the Bank of Japan at that time, states as follows. Increase in interest rates had not been discussed at the executive board of directors. He fell to thinking that the official discount rate should be raised. Yet, he did not advocate this idea and refrained from saying outside the Bank of Japan that he cared about inflation, for he feared that the Bank of Japan and Vice-Governor Mieno would be criticized further if the Bank of Japan alone advocated raising its official discount rate as the Ministry of Finance had already blamed Mieno for Black Monday and calls for international policy coordination were growing among the Ministry of Finance and journalism in 1988[79)].

Mikio Wakatsuki, who served as Adjutant General of the Bank of Japan at that time, remarks as follows. Though he had explored opportunities to raise the official discount rate since the middle of 1988, he got no feeling that the Ministry of Finance accepted it because the Ministry wanted to introduce the consumption tax without much trouble. An official of the Ministry of Finance said to him that the Bank of Japan would go against the efforts to expand domestic demand, Japan being chastised for its large trade surplus. Although he stressed the soaring land prices, the Ministry of Finance answered that only the land prices in Tokyo had surged and that it was natural because Tokyo was getting the financial center which matched New York and London[80)].

Akira Sato, who interviewed directors of the Bank of Japan at that time, argues as follows. The directors of the Bank of Japan heard secondhand that the executive officials of the Ministry of Finance and the caucus of the LDP remarked off the record that Vice-Governor Mieno, who repeated that increase in interest rates was needed in order to prevent inflation, was not suited to be the governor of the Bank of Japan. Sato concludes that the less independence of the Bank of Japan was the cause of holding the official discount rate steady[81)].

The government and the Ministry of Finance opposed rise in interest rates for the following reasons. First, Japan-U.S. trade friction was igniting. Office of the United States Trade Representative intended to identify Japan as an "unfair trading country," based on Super 301 clause of the Omnibus Trade Act. The Ministry of International Trade and Industry which negotiated with the U.S., the Ministry of Finance which was afraid of being demanded expanding government spending, and

79) Mizuno, *Nichigin Himerareta "Hanran,"* p.169.

80) Takeshi Yamawaki, *Nihon Ginko no Shinjitsu* [Truth about Bank of Japan] (Tokyo: Daiyamondosha, 1998), pp.21-22.

81) Sato, *Dokyumento Kin-yu Hatan*, pp.343-345.

Prime Minister Noboru Takeshita were concerned that the U.S. would recognize increase in the official discount rate as abandonment of policy to expand domestic demand. Second, the Ministry of Finance faced the opposition parties' objection against introduction of the consumption tax. The opposition parties argued that the tax would encourage follow-up price hikes. It was unfavorable for the Ministry of Finance that the Bank of Japan announced inflation worries since this reinforced the argument of the opposition parties[82]. Third, the International Finance Bureau of the Ministry of Finance supported the international opinion that Japan should not raise interest rates to the last in order to shore up the world economy[83].

Under such circumstances, it was difficult for the Bank of Japan to raise its official discount rate. However, there are no evidences that the Bank of Japan tried to raise the rate and that the Ministry of Finance or the LDP prevented the Bank from it. In fact, the executives of the Bank did not reach an agreement on it.

Takashi Ota, Executive Director who was in charge of international affairs, made strong opposition to it. He argued that it would lead to collapse of the dollar[84]. The executives of the Bank of Japan consider his argument to be very persuasive because increase in short-term interest rates in West Germany had caused the collapse of the New York Stock Exchange on October 19, 1987[85]. Vice-Governor Mieno stated afterward that the Bank of Japan could not help taking account of the possibility that tight monetary policy in Japan would have adverse effects on the world economy after the shock of Black Monday[86]. Even Yoshio Suzuki singled out the possibility of collapse in the value of the dollar as the main reason for keeping the official discount rate steady in his book[87].

Within the Bank of Japan, the executives were divided into two factions on increasing the official discount rate. Six Directors-Generals had a secret meeting within the Bank every Tuesday in 1988. In the second half of 1988, increase in the official discount rate was discussed at the meeting. Three Directors-Generals, who belonged to "*Kokunai-Ha*," advocated interest rate increase on the grounds that the U.S. and West Germany raised interest rates and asset prices continued to soar. On

82) Mizuno, *Nichigin Himerareta "Hanran,"* p.170.

83) Noguchi, *Nichi-bei Tsuka Kosho 2000 Nichi*, pp.229-230.

84) Mizuno, *Nichigin Himerareta "Hanran,"* pp.171-172.

85) Sato, *Dokyumento Kin-yu Hatan*, pp.342.

86) Yasushi Mieno, *Nihon Keizai to Chuo Ginko* [Japanese Economy and Central Bank] (Tokyo: Toyo Keizai Shimposha, 1995), pp.38-39.

87) Yoshio Suzuki, *Nihon Keizai no Saisei* [Rebirth of Japanese Economy] (Tokyo: Toyo Keizai Shimposha, 1992), pp.19-24; Yoshio Suzuki, *Nihon no Kin-yu Seisaku* [Japanese Monetary Policy] (Tokyo: Iwanami Shoten, 1993), p.100.

the other hand, three Directors-Generals including Wakatsuki, who belonged to "*Kokusai-Ha*," objected interest rate hike based on the reasons stated below. First, international cooperation has to be kept. Second, the consumption tax that will be introduced in April 1989 will have a negative impact on the economy. Third, both wholesale prices and consumer prices are stable[88)].

It has been often said that the Bundesbank had raised its official discount rate four times before the Bank of Japan raised the rate of it in May 1989. The Bundesbank succeeded in raising the rate swiftly without respect to politicians who were reluctant to raise the rate in consideration of the relationship with the U.S., as opposed to the Bank of Japan. This difference is perceived to be derived from the different level of independence of them[89)]. However, this argument neglects the difference between the yen-dollar rate and the mark-dollar rate. Throughout the year, the dollar had been so weak and seemed on the point of tumbling against the yen, though it had been stabilized against the mark[90)]. Thus, the Bundesbank could raise interest rates leaving the exchange rate out of consideration. The yen-dollar rate was stable temporarily in summer 1988, to be sure, but it was worried that the yen would soar again[91)]. In fact, the yen rose sharply again since October and reached a peak on November 17[92)]. The Bank of Japan had to guide short-term interest rates to lower in order to stop the dollar's depreciation against the yen[93)].

More importantly, in West Germany, import prices began to rise owing to the weak mark. Thus, tight monetary policy was implemented as preventative measure for putting brakes on the lower mark and eliminating the growing inflationary mentality[94)]. On the contrary, prices of commodities never rose in Japan in spite of the asset inflation. There were some reasons of this. First, the strong yen and declining oil prices brought prices down. Second, wages were held down relatively to the buoyant economy[95)]. Third, inflationary expectations did not rise because the

88) Norifumi Tsukada interviewed Jun-ichi Miyake who had served as Director-General of Institute for Monetary and Economic Studies at that time (September 10, 2001).

89) See, for example, Henning, *Currencies and Politics in the United States, Germany, and Japan*, p.323; Mizuno, *Nichigin Himerareta "Hanran,"* pp.173-175; Sato, *Dokyumento Kin-yu Hatan*, pp.342-344; Yamawaki, *Nihon Ginko no Shinjitsu*, pp.20-21.

90) Takashi Ota, *Kokusai Kin-yu Genba kara no Shogen* [International Finance: Testimony from the Scene] (Tokyo: Chuo Koronsha, 1991), pp.117-119; Suzuki, *Nihon Keizai no Saisei*, pp.20-22; Suzuki, *Nihon no Kin-yu Seisaku*, pp.96-98.

91) *Asahi Shimbun*, September 9, 1988.

92) *Asahi Shimbun*, November 18, 1988.

93) *Asahi Shimbun*, October 18, 1988, October 20, 1988.

94) *Asahi Shimbun*, July 1, 1988.

95) Kazuo Ueda, *Kokusai Shushi Fu-kinko ka no Kin-yu Seisaku* [Monetary Policy under Unbalance

Bank of Japan had built up a high reputation as a price-stabilizing central bank over the past 20 years[96].

Now, we need recall the causes of the soaring of land prices and stock prices I argued in Chapter 2. It is incorrect that the Bundesbank's tightening monetary policy prevented asset price inflation. In West Germany at that time, stock trading was not active and strict regulations were imposed on land use. That is, there were no fundamentals that inflated the stock and land prices in West Germany[97]. In Japan, excess liquidity by low interest rates was absorbed by stock market investment and real estate investment and did not raise inflationary expectations, but in West Germany, excess liquidity by low interest rates raised inflationary expectations. Therefore, the Bundesbank raised interest rates to curb accelerating inflation.

Most economists argued that the Bank of Japan should have pursued a tight monetary policy on the grounds of the rapid growth in monetary aggregates in the second half of the 1980's[98]. However, the Bank of Japan managed monetary policy with the emphasis not on the money supply but on the short-term interest rates because it believed that central banks could not control the money supply. It insisted that increase in demand for fund caused the rapid growth in monetary aggregates[99].

To be sure in 1975, the Bank of Japan announced a new monetary-policy procedure emphasizing the importance of the money supply as a fundamental determinant of inflation and the usefulness of monetary growth as an intermediate policy indicator. It is said that the Bank of Japan had implemented "money-focused" monetary policy since then. However, Cargill, Hutchison, and Ito argue that the Bank of Japan focused on interest rates and did not adhere to *k*% rule between 1975 and 1986. Its operations were not monetarist. Cargill et al. conclude that the Bank of Japan achieved the objective of price stability by nonmonetarist

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of Payments Equilibrium] (Tokyo: Toyo Keizai Shimposha, 1992), pp.186-187; Hiroshi Yoshikawa ed., *Kin-yu Seisaku to Nihon Keizai* [Monetary Policy and Japanese Economy] (Tokyo: Nihon Keizai Shimbunsha, 1996), pp.143-144.

96) Kazuhide Uekusa, *Kinri Kawase Kabuka no Seiji Keizaigaku* [Political Economy of Interest Rates, Currency Exchange, and Stock Prices] (Tokyo: Iwanami Shoten, 1992), pp.36-37, pp.93-94.

97) Aizawa, *Nichigin-Ho Nijugo-Jo Hatsudo*, pp.84-93.

98) See, for example, Kikuo Iwata, *Kin-yu Seisaku no Keizaigaku* [Economics of Monetary Policy] (Tokyo: Nihon Keizai Shimbunsha, 1993).

99) See, for example, Kunio Okina, *Kin-yu Seisaku* [Monetary Policy] (Tokyo: Toyo Keizai Shimposha, 1993).

means[100].

In 1980's, the advance in financial liberalization weakened the relationship between the money supply and commodity prices and diluted the validity of the money supply as an intermediate policy indicator[101]. In other industrial nations, central banks abandoned any attempt to target monetary aggregates[102]. Moreover, the Bank of Japan might interpret the monetary increase as portfolio shifts triggered by deregulation[103]. Mieno himself acknowledged it afterward[104]. Thus, restrictive monetary policy was not pursued in spite of the rapid money growth.

Because "*Kokunai-Ha*" within the Bank of Japan, including Vice-Governor Mieno, was cautious about the increase in commodity prices, its arguments against low interest rates were hardly convincing as commodity prices were very stable despite soaring asset prices. In those days, the inflated asset prices were viewed not as causes of the wide economic fluctuations, the nonperforming loan problem, or the financial instability in the future, but as detriments to equity in income distribution and property and as causes of inflation in the future[105]. Therefore, the rapid money growth was neglected and most people did not think that bubble economy had to be burst as early as possible.

Satoshi Sumita mentions that monetary easing was necessary to correct the imbalance of international payments and to avoid collapse of the dollar. He emphasizes that commodity prices were stable and the inflation rate was about 0% for three years since 1986[106]. Yasushi Mieno remarks that people did not become aware easily that the excess liquidity was focused on the asset market because the inflation rate based on consumer price index hardly rise thanks to the strong yen[107]. He also says that wholesale prices were negative growth and both the government and the private sectors considered it strange that the Bank of Japan took monetary policy in order to control asset prices[108]. Hence, he concludes that he considers

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100) Cargill, Hutchison, and Ito, *The Political Economy of Japanese Monetary Policy*, pp.35-49.

101) Mitsuaki Okabe, *Kankyo Henka to Nihon no Kin-yu* [Environmental Changes and Finance in Japan] (Tokyo: Nihon Hyoronsha, 1999), p.493.

102) Alan S. Blinder, *Central Banking in Theory and Practice* (Cambridge: The MIT Press, 1998), pp.26-29; Okina, *Kin-yu Seisaku*, pp.153-157.

103) Cargill, Hutchison, and Ito, *The Political Economy of Japanese Monetary Policy*, p.57.

104) Yasushi Mieno, *Gi wo Mite Ri wo Omou* [Seeing Social Obligations to Ponder about Interest Rate] (Tokyo: Chuo Koron Shinsha, 1999), p.84.

105) Okina, Shirakawa, and Shiratsuka, "Shisan Kakaku Baburu to Kin-yu Seisaku."

106) *Nihon Keizai Shimbun*, October 29, 1993.

107) Mieno, *Nihon Keizai to Chuo Ginko*, p.38.

108) Mizuno, *Nichigin Himerareta "Hanran,"* pp.166-167; Okina, *Kin-yu Seisaku*, pp.165-166.

long-term easy monetary policy to be inevitable and reasonable to a certain degree because of the sharp appreciation of the yen, the stability of commodity prices, and the collapse of the New York Stock Exchange on Black Monday[109)].

It was common knowledge that central banks should not use monetary policy to stabilize asset prices since asset prices are determined by various factors other than interest rates[110)]. Moreover, loosening monetary policy by the Bank of Japan was not the root cause of the asset inflation in those days. There were a lot of factors which led to it before the Bank eased money, as I argued in Chapter 2. Thus, the Bank of Japan thought that it reflected the actual demand to a considerable extent. Accordingly, the Bank could not regard it as the bubble phenomenon caused by loosening monetary policy, and was not able to see the need to curb it by tightening monetary policy.

In fact, it is said that Yoshio Suzuki told in 1987 that the increase in stock prices and land prices was natural because incomes of Japanese rose[111)]. He also told that soaring land costs in Tokyo was not caused by speculations on land but reflected the added value of it and that rise in stock prices and land prices helped to put the economy on track for recovery[112)].

Akira Kanno, who served as an Executive Director of the Bank of Japan at the time, tells that he thought that the rapid appreciation of stock prices merely reflected re-evaluation of Tokyo stock market and that the rise in land prices was the outcome of productivity growth of land typified by demand for office buildings, which also reflected re-evaluation of the Japanese economy[113)].

Nobuhito Kishi reports that in face of stable wholesale price index and consumer price index, there were few opinions in the meetings of executive directors that monetary policy should be used to deal with the asset price inflation. He also reports that rise in the official discount rate began to be discussed within the Bank of Japan in the end of 1988[114)].

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109) Mieno, *Gi wo Mite Ri wo Omou*, pp.206-207.

110) Cargill, Hutchison, and Ito, *The Political Economy of Japanese Monetary Policy*, p.113; Mitsuaki Okabe, "Kin-yu Kankyo no Henka to Kin-yu Seisaku" [Environmental Changes in Finance and Monetary Policy]. In Yoshio Suzuki, and Mitsuaki Okabe eds., *Jissen Zeminaru Nihon no Kin-yu* [Practical Seminar: Finance in Japan] (Tokyo: Toyo Keizai Shimposha), pp.245-289.

111) Atsushi Yamada and Soichiro Tahara, *Nihon Sai Haiboku* [Japan Lost Again] (Tokyo: Bungei Shunju, 1998), p.147.

112) Mizuno, *Nichigin Himerareta "Hanran,"* p.171.

113) Kishi, *Kenjin Tachi no Gosan*, p.53.

114) Ibid., pp.53-54.

In fact, the Bank of Japan announced its intention not to raise its official discount rate in July and August 1988 when the Bundesbank increased interest rates, pointing out the stability of commodity prices and the difference between the yen-dollar rate and the mark-dollar rate[115]. In September 1988, Mikio Wakatsuki told in an interview that Japan did not endure raising the official discount rate though Japan was rated highly for not following rise in interest rates in the U.S. and West Germany. He explained that Japan did not have to raise it in the current economic environment[116].

These facts show that the Bank of Japan was not forced to keep an easy money policy by the Ministry of Finance, the LDP politicians, and the U.S., and that it did not raise its official discount rate on its own will. It is true that there were political pressures on the Bank of Japan about Mieno's promotion to the governor. However, there were three reasons that the Bank of Japan kept interest rates low. First, the Bank of Japan was concerned about a sudden depreciation of the dollar. Second, the Bank of Japan did not perceive that the asset inflation would cause too serious problems in the future. Third, the Bank of Japan had no positive reasons to tighten monetary policy because there were no signs of an increase in inflationary pressures.

Another evidence for my argument can be derived from the fact that the Bank of Japan increased its official discount rate from 2.5% to 3.25% in May 1989. In these days, it is said that this hike in official rate was too late. However, this was not regarded as necessarily urgent measure in those days. Actually, widely-circulated newspapers declared in their editorials that increase in interest rates would not be necessary for the time being[117]. Although the yen kept weakening at a sluggish pace at that time, commodity prices did not rise so high that increase in interest rates was required[118]. Moreover, the Ministry of Finance was opposed to it because the opposition parties objected to introduction of the consumer tax in April 1989 by reason of follow-up price hikes. Furthermore, the Ministry of Finance was afraid that the U.S. might consider it to be abandonment of policy to expand domestic demand and request expanding government spending again. Besides, Japan-U.S. Structural Impediments Initiative was going to be held in September 1989. However, the Bank of Japan decided to raise its official discount rate as a precaution against inflation.

115) *Asahi Shimbun*, July 1, 1988, August 26, 1988.

116) *Asahi Shimbun*, September 9, 1988.

117) See, for example, *Asahi Shimbun*, February 26, 1989; *Nihon Keizai Shimbun*, March 26, 1989.

118) *Shukan Toyo Keizai*, June 10, 1989.

If the Bank of Japan was forced not to raise its official discount rate by the government and the Ministry of Finance in 1988, the reason why the Bank of Japan raised the rate in May 1989 can not be explained because neither the government nor the Ministry of Finance endorsed increase in the rate at that time similarly. If the political pressures on the Bank of Japan about Mieno's promotion to the governor were the main reason of the Bank of Japan's indetermination in 1988, the Bank of Japan should not have run the risk in May 1989. Increase in the official discount rate at that time had the potential to draw condemnation of Mieno from the government and the Ministry of Finance. Nevertheless, the Bank of Japan adhered to it and persuaded the Ministry of Finance to approve it.

There were three reasons that the Bank of Japan decided it. First, the U.S. trade deficit with Japan narrowed thanks to the economic expansion of Japan. Second, strong dollar policy of the Bush Administration depreciated the yen and cut the risk of collapse of the dollar. Third, and this is the most important, commodity prices rose to the slightest degree. That is, the official discount rate was not raised in 1988 because there were no signs of an increase in inflationary pressures. However, in 1989, there were faint signs of it. Therefore, the Bank of Japan determined increase in its official discount rate as a preventative measure. This corresponds to the conventional attitude of the Bank that gives top priority to the stability of commodity prices.

5. Conclusion

In this article, I have demonstrated that the low level of the Bank of Japan's independence from the government and the Ministry of Finance did not cause the bubble economy. The Bank of Japan had no incentives to tighten monetary policy for the following reasons. First, the Bank could not perceive that the inflated asset prices were bubble (that is, they did not reflect the real demand) on the grounds that the asset prices had been inflated before it loosened monetary policy. Second, it did not have a clear-eyed awareness of the need to burst the asset bubble since it did not recognize that the asset price bubble would harm the economy in the future. Third, increase in interest rates was at high risk of giving rise to collapse of the dollar. Fourth, commodity prices were very stable. In sum, the Bank of Japan had no positive reasons to increase its official discount rate in order to burst the asset price bubble.

There might be some objections against this argument. I will conclude this article by answering these expected objections.

First, it might be seen as a problem that the Bank of Japan was dependent on the government about personnel management. Satoshi Sumita, who had served as Administrative Vice-Minister of Finance, served as Governor of the Bank of Japan. His background seemed to prevent him from being fully aware of the significance of the independence of the Bank of Japan from the government. Therefore, he might decide to lower interest rates without careful consideration.

Also, the government had the power to appoint the governor of the Bank of Japan, so that this could bring pressures upon the Bank by implying the government's opposition to Mieno's promotion to the governor of the Bank.

Conventionally, a former Administrative Vice-Minister of Finance and a former executive of the Bank of Japan were appointed as the governor of the Bank of Japan by turns. This tradition was criticized because it enabled the Ministry to govern the Bank.

However, it was a favorable rule to the Bank. In 1964, there was a conflict over the governor post between the Ministry and the Bank. Prime Minister Eisaku Sato took the occasion to appoint a private bank president as the governor[119]. The tradition that the Bank and the Ministry got the position by turns seems to be based on reflection on this. The Bank became able to get the position certainly once in twice.

It is not a problem that the governor of the central bank is appointed by the government because it is a common practice in democratic countries. What is important is whether the governor of central bank is able to manage monetary policy of his/her own will.

Second, it might be viewed as a defect in a decision-making system of the Bank of Japan that the governor could make an arbitrary decision on changing the official discount rate. At the Policy Board, the governor as well as other four voting members appointed by the cabinet had only one vote. Hence, this enabled four voting members to override the governor's suggestions if he/she made the proposals in behalf of the government. For example, the Bundesbank decided to raise interest rates in April 1989 though the President opposed it[120]. However, the Policy Board of the Bank of Japan lapsed into the practice of following the recommendations

119) Ushio Shiota, *Okura Jimu Jikan no Tatakai* [The Struggle of the Administrative Vice-Minister of Finance] (Tokyo: Toyo Keizai Shimposha, 1995), p.150.

120) Henning, *Currencies and Politics in the United States, Germany, and Japan*, pp.89-90; David Marsh, *Doitsu Rengin no Nazo* (Tokyo: Daiyamondosha, 1993), pp.82-88 [English version, David Marsh, *The Bundesbank: The Bank That Rules Europe* (London: William Heinemann Ltd, 1992)].

made by the executive board of directors within the Bank[121]. Accordingly, the Policy Board was called "Sleeping Board." Therefore, it might seem better than "Sleeping Board" that the Policy Board was the main policy-making body of the Bank.

However, it was also possible that voting members who went along with the government decided to loosen monetary policy despite the governor's opposition like the "palace coup" of the FRB in February 1986. Especially in Japan, because there was little opportunity for alternating government among different parties, board members who were appointed by the government would have been likely to decide the policies in line with the government's expectations if the Policy Board had had the real power.

In the case of the Bundesbank, it was important that the Central Bank Council members did not have the only one partisanship since the majority of them were the presidents of the Land Central Banks of 11 provinces who were appointed by Land governments, not by the central government[122].

Thus, it enhanced rather than undermined the independence of the Bank of Japan that the executive board of directors which was composed of the officials of the Bank but one Finance Ministry official who was transferred temporarily had the real power.

Finally, there may be objections that I overemphasize the independence of the Bank of Japan. Even if the executives of the Bank of Japan did not reach an agreement on increase in the official discount rate in 1988, the Bank of Japan could have increased it sooner if the Bank had been independent of the government and the Ministry of Finance completely.

It is true that the Bank of Japan was not independent completely, but there are no central banks that are independent of the government completely. As for example, I show the case of the Bundesbank.

John B. Goodman, who studied the politics of central banking in Western Europe, states that

> the Bundesbank has been cognizant of the fact that its independence ultimately rests on societal support, and it has long taken that support into account in fashioning monetary policy. For this precise reason, the Bundesbank has sometimes given ground—that is, it has acceded to pressures

121) Cargill, Hutchison, and Ito, *Financial Policy and Central Banking in Japan*, p.89.

122) Marsh, *Doitsu Rengin no Nazo*, pp.77-78.

> for greater monetary expansion. In general, the Bank has done so only when two conditions have been met: first, when monetary expansion enjoyed overwhelming support within West Germany and abroad, and second, when the pursuit of such a policy did not threaten to ignite domestic inflation[123].

He takes two cases for instance.

> One episode, for example, occurred in 1967-68, just after the formation of the grand coalition, when in response to heavy political pressure the Bundesbank agreed to facilitate the placement of government debt and thereby help finance an ambitious deficit spending program. More recently, in 1978, the Bundesbank acquiesced in government demands that it set monetary policy in line with a major stimulus package, which Germany had accepted as part of the Bonn summit agreement. Both of these examples involved conflicts over economic policy during periods of economic stagnation when broad sections of German society favored a more expansionary policy. Although the central bank disagreed with the direction of fiscal policy on both occasions, it realized that its independence might not weather a protracted struggle against popular government policies. By giving ground, the Bundesbank protected its independence and its ability to resist pressures for expansion over the long run[124].

Additionally, I can take another case that in December 1987, the Bundesbank lowered the official discount rate, accepting the request for this from the government[125].

Even the Bundesbank whose high level of independence was set by law had to accede to pressures for greater monetary expansion in some cases. In democratic countries, it is impossible for central banks to neglect the governments' wishes completely. Central banks must take them into account up to a point. Thus, central banks try to manage monetary policies which reflect their desires as much as possible, operating money market in a strategic way and appealing to public opinion and mass media. In comparison with central banks in other nations, the

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123) John B. Goodman, *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca: Cornell University Press, 1992), p.59.

124) John B. Goodman, "The Politics of Central Bank Independence," *Comparative Politics* 23, no.3 (1991): 329-49.

125) Marsh, *Doitsu Rengin no Nazo*, p.235.

Bank of Japan managed monetary policy autonomously to significant extent though the law admitted less independence.

I have demonstrated in this article that the Bank of Japan was independent from the government and the Ministry of Finance to an extent that was important and that the Bank ultimately decided to loosen monetary policy on its own volition.