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INTERNATIONAL POLICY COORDINATION AND CENTRAL BANK INDEPENDENCE*

YOSHINORI SHIMIZU

Abstract

Central bank independence is a key concept in the worldwide trend of financial system reform. The statutory independence, however, is not a guarantee of error-free monetary policy. This paper examines the process of policy making of the G-7 countries in the late 1980s under the banner of international policy coordination pursued by the U.S. government. This policy by the U.S. affected the Bank of Japan's decision making which became one cause of the bubble economy in Japan in the late 80s. The independence of the Bank of Japan was impaired by the domestic government that was influenced by the foreign governments. This paper compares the behavior of central banks in the U.S., Japan and Germany and evaluates the degree of independence revealed by each central bank. The core of central bank independence is the unflinching determination of the central bank itself to insist its policy rule that aims exclusively for the price stability and refuses political pressure to fine tune business activities.

Introduction

The Plaza agreement in 1985 initiated a trend of international policy coordination which heavily impacted the economic policies of developed countries in the 1980s. Japan's speculative bubbles in asset prices in the 1980s can partly be attributed to the policy of the Japanese government which did not resist the pressure from the U.S. on the implementation of Japanese economic policy, based on the idea of international policy coordination. The U.S. exchange rate and trade policy in the mid-1980s was recognized as economically unwarranted at that time by most economic scholars in the academic circle. Nevertheless, international policy coordination was pursued under the leadership of politicians and, as theoretically expected, this resulted in serious negative impacts to the economies of many countries and, thus, to the world in the long run. This painful experience provides rich insights to the problem of political influence on monetary policy and central bank independence.

In the following, we will take a brief look at how the idea of policy coordination emerged and was implemented within the U.S. government, how it affected economic policies in other countries, especially Japan, why Japan experienced the worst speculative bubbles in the world.

* This paper was written during the author's stay at the Financial Markets Group of the London School of Economics as an academic visitor. I am grateful for the helpful comments and discussions with Professor C. E. A. Goodhart and other members of the Financial Markets Group.
FIGURE 1. Nominal and Real Value of the Dollar, Morgan Guaranty Indices (1980–82 = 0)

Source: Feldstein ed. 1994, p.294

FIGURE 2. The Monthly U.S. Trade Balance (Unit: $Billion)

Source: Feldstein ed. 1994, p.631
that now threaten the entire Japanese financial system, and how central bank independence should be established in order to secure an error-proof monetary policy.¹

I. The Dollar Appreciation and the Increased Trade Deficit²

Since 1971, the exchange rate value of the dollar was on a downward trend, along with an increasing rate of inflation; in 1980 it turned to an upward trend and continued upwards until the beginning of 1985, as shown in Fig. 1. As a result, the inflation adjusted trade-weighted value of the dollar compared to the currencies of 10 other developed countries rose 73% during the period from 1979 to the first quarter of 1985. This change was caused by the fact that the dollar's attractiveness to foreign investors was enhanced by the rise in real interest rates and the reduced risk of further inflation through the initiation of the Federal Reserve Board's determined tight monetary policy to reduce the inflation rate. In addition, it was anticipated from the outset of President Reagan's administration that stronger anti-inflation and tax reduction policies would be followed. Reagan's plan to increase defense spending also meant future increases in the budget deficit and a resulting rise in interest rates. An increased budget deficit, accompanied by the FRB's policy of suppressing the rate of money growth, translated into a rise in real interest rates without inflation.

The rise in the value of the dollar continued throughout 1983 and 1984, after a mild, temporary fall in late 1982 when the FRB turned to an easy money policy as inflation was clearly subsiding. As shown in Table 1 and Figure 3, however, the rapid increase of the budget deficit was an actual threat already in 1982 and 1983. The larger budget deficit, which peaked in 1985 and 1986, was expected by investors and thus the dollar kept rising during 1983 and 1984.

As a natural result of the rise of this magnitude in the dollar, the trade deficit rapidly increased after 1980 as is shown in Fig. 2. The trade deficit level rapidly increased from $15 billion or 0.5% of GNP in 1980 to $36 billion in 1982, $67 billion in 1983, $113 billion in 1984, to its worst at $143 billion or 3% of GNP in 1987. In the mid 1980s, therefore, the large trade deficit became a major political issue. Manufacturing industries suffered severely from rapidly reduced exports and the surge of imports; the "hollowing-out" of industries became a point of discussion. The reduced competitiveness of U.S. industries created massive self-criticism. Shortsightedness of management, poorly educated labor, non-cooperative labor-management relationships, lack of capital formation, and lack of interest in international markets were blamed. The Japanese way of management was highlighted and praised. Several business observers advocated Japan as the leader of world industry. Nonetheless, the U.S. unemployment rate did not rise, thanks to a rather smooth shift of labor from the manufacturing sector to the newly expanding service sector. The point of the issue, however, was that the loss in competitiveness of the manufacturing sector was due to the rise in the value of the dollar.

Influenced by the voice of industry, the U.S. Congress and the Department of Commerce started to blame the closed nature of foreign markets for the large trade deficit. Japan, with

TABLE 1. FEDERAL RECEIPTS, OUTLAYS, AND DEFICITS, 1950–89

<table>
<thead>
<tr>
<th>Years</th>
<th>Outlays</th>
<th>Receipts</th>
<th>Deficit</th>
<th>Outlays</th>
<th>Receipts</th>
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<tr>
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<td>19.0</td>
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<td>1970-79</td>
<td>324.2</td>
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<td>156.4</td>
<td>23.1</td>
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<td>192.8</td>
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<td>1971</td>
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<td>20.0</td>
<td>18.0</td>
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<td>23.1</td>
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<td>1985</td>
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<td>212.3</td>
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<td>5.3</td>
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<td>22.7</td>
<td>19.3</td>
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<td>155.1</td>
<td>22.2</td>
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<td>1989</td>
<td>1,142.6</td>
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<td>152.0</td>
<td>22.2</td>
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<td>1990</td>
<td>1,251.9</td>
<td>1,031.5</td>
<td>220.4</td>
<td>23.2</td>
<td>19.1</td>
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* Transition quarter.

Source: Feldstein ed. 1994, p.237

whom the U.S. trade deficit was largest, came under increasing attack. This condemnation to Japan and the protectionist movement in the U.S. Congress terrified the Japanese government and urged to take some measures.

Although foreign markets were indeed closed to some degree, there was nothing at all new in this. If anything, there was a tendency towards more open markets and thus this cannot be a meaningful factor in explaining the rapid increase of the U.S. trade deficit in the early 1980s. Even if the absolute fall in the competitiveness of U.S. industry compared to other countries actually happened, it is clearly not a cause for the surge in the trade deficit, because trade is based on the relative cost of production.

Reduced exports to Latin American countries that were suffering from their accumulated debts problem, reduced agricultural exports to China due to its increased agricultural productivity, and increased competitiveness of Asian NEIS were among factors which partly explain the trade deficit. These factors, however, will never be the main reason for a trade deficit of this magnitude. The main cause was undoubtedly the rise of the dollar that increased
as much as 73% during the first five years of 1980s. Economists both in academia and government understood the relationship between the trade deficit and the rise of the dollar which was caused fundamentally by the budget deficit. These economists were generally against protectionism and managed trade. The Council of Economic Advisers, which was led by Feldstein, repeatedly advocated that the trade deficit is a natural result of excess investment over savings, which in turn was caused by the large budget deficit. Despite Feldstein's repeated efforts to explain that a reduction in the trade deficit without reducing the budget deficit would not improve economic performance, the need to cut the budget deficit in order to solve the problem was never acted upon by the Reagan administration.

Secretary of the Treasury, Donald Regan, did not understand the cause to be the budget deficit. He believed, rather, that a strong dollar represented a strong U.S. and consistently opposed a deliberate fall in the value of the dollar through market intervention. President Reagan as well, despite pleas from industry for intervention to reduce the strong dollar, believed that the dollar's value should be left to the market. Volcker, the Chairman of the FRB at that time, inherently opposed the weak dollar due to the fear of its negative effect on domestic prices. He understood that the only way for the FRB to reduce the dollar was to raise the inflation rate through an easy money policy. Up until 1984, therefore, the exchange rate policy of the Reagan administration was consistently characterized by a laissez-faire policy called "benign neglect."

In the mid 1980s, several advocates argued for the need for an orderly reduction of the over-valued dollar, which was called the "sustainability problem." The high dollar price, however, was sustained simply because investors believed that their dollar investments were remunerative after taking the risk of the dollar's plunge into account. The expected value of the risk adjusted real differential of the interest rate compared with those of other currencies was higher than its expected cost. If the dollar were over valued, it would be clear that the
dollar would fall anyway at some time, and that the trade deficit would be eliminated. The reason for the continued rise of the dollar and the continued expansion of the trade deficit in 1983 and 1984 was the fact that further increases in the structural budget deficit were expected at that time.

At the beginning of 1985, however, the dollar's value reached a level that could not be justified by the interest rate differentials. The U.S. foreign debt had increased to a level such that U.S. foreign interest and dividend payments would grow faster than GDP, even if the trade deficit would be eliminated by the dollar's fall. At this stage, it was clear to everybody that the dollar was pushed up to an extreme level due to speculative bubbles. From February 1985, a rapid fall of the dollar ensued.

II. New Policy of James Baker

At the beginning of 1985, reflecting the expanding trade deficit and the slumped export industries, protectionism increasingly took hold in the U.S. Congress and trade friction between the U.S. and Japan reached a serious stage. During the Reagan and Bush administrations, three ideas on trade policy coexisted with varying degrees of influence. The first was an idealistic free trade policy mainly put forward by the CEA. The second was a more pragmatic political reaction pursued by the U.S. Trade Representative (USTR) and the White House staff. The third was active managed trade advocated by the Department of Commerce. By this time, however, the lessez-faire trade policy pursued by the first Reagan administration was under serious attack by protectionists in the Congress. The Congress actively intervened in the trade policy and tried to pursue protected trade.

At this time, James Baker, who was a chief advocate of the second position replaced Regan as Secretary of the Treasury. Baker, as a powerful, pragmatic politician, wanted to adopt his own policy to solve the problem. The new policy, called "international policy coordination," was aimed at reducing the value of the dollar, responding to the voice of the industrial sector and to public opinion. This policy was intended to meet the demands of Congress as well as to fight the ever increasing pressure toward protectionism. The idealism of free trade had lost its influence within the Reagan administration.

Nevertheless, in order to change the complete free trade policy pursued so far by the administration, the support of George Shultz and Volcker, who were believers in free trade, was needed. Shultz, as the Secretary of State, clearly realized the strong wish to adjust the high dollar by foreign countries, and advocated reorganizing the yen-dollar relationship. Indeed, his strong plea, through Japan's Ministry of Foreign Affairs, was a major factor that made the U.S.-Japan yen-dollar committee accord possible in 1984. Shultz's argument for the reorganization of the yen-dollar relationship gave Baker strong support in devising his new policy.

Baker took special care to persuade Shultz and Volcker. Eventually, Shultz agreed with the new policy, but commented that a specific level of the dollar not to be mentioned and that "intervention was not a panacea." Volcker inherently disliked the weak dollar and strongly opposed a reduction of interest rate in order to reduce the dollar because markets could interpret such a move as a signal of the FRB's abandonment of its anti-inflation policy. Thus,
monetary policy could not be used to impact exchange rate policy. As long as monetary policy was not affected, however, Volcker would not oppose the new exchange rate policy which uses intervention measures under the Treasury's control. In fact, he rather approved of such a new exchange rate policy and international policy coordination as discussed later. Although his public comments consistently opposed the weak dollar, much in contrast to Baker's public comments of "talking down the dollar", even contradictory, he spoke in this way intentionally to avoid an uncontrollable fall in the dollar, in counterbalance to Baker.4

Baker and his staff were careful to avoid giving any impression that the new policy was an intervention to the monetary policy. Especially in the U.S., they never initiated official activity which could be interpreted as pressure on monetary policy. Also, in repeated discussions with G-5 or G-7 countries regarding their policy coordination, they never talked officially about their monetary policy. Their agenda was macroeconomic policy, and the method and scale for market intervention. This is because central bank governors of each country did not want to discuss officially topics which could infringe upon their independence; the U.S. clearly recognized this problem. Negotiations on monetary policy were, therefore, conducted unofficially, personally, and on a bilateral basis between countries. Even in these unofficial bilateral negotiations, German central bankers were consistently firm and stubborn regarding their independence. As a result, Japan, who was another main target and at the same time sympathetic to the American position, was most affected by the U.S. political leadership. Baker was consistently not active in the intervention itself, despite frequently speaking about his intention to change the value of the dollar.

Finally, President Reagan believed that the exchange rate should be left to the market, yet he was nostalgic about the gold standard and the fixed exchange rate system. He was sympathetic to the idea of tightening exchange rate controls in order to reduce exchange rate instability. Baker presented his new policy plan to President Reagan just a few days before the Plaza meeting. Reagan agreed with it and rarely revisited the issue, creating a vague position which gave Baker wide latitude to exercise his own discretion. And Baker was careful to push the new policy forward in gradual steps to avoid emotional outcries against rapid policy change.

III. The Plaza Accord

From February 1985, the value of the dollar went into rapid decline. First of all, the market expected a new policy aimed at achieving a weaker dollar to be implemented under the leadership of the new Secretary of the Treasury, James Baker. The market sold dollars based on this expectation. Secondly, Germany made large scale interventions in February and March following the agreement reached at the G-5 meeting in January 1985 in which Baker and Undersecretary Darman participated. Germany's intervention was exquisite in its timing, and triggered an important momentum, reversing the market trend, and bursting speculative bubbles in the dollar. This success was attributed to Baker rather than the Germans, for indeed Baker enjoyed massive press coverage from his seat at the center of political power in Washington.

When the value of the dollar started to fall, the central issues with the new policy shifted to the problems of how to seek fiscal stimulus in each country. Baker, from the beginning, aimed to increase U.S. exports through increased GNP growth in Japan and Germany. This "locomotive strategy" allocated the responsibility for solving trade imbalance to the fiscal expansion of other countries and it faced strong criticism even within the administration, including the Undersecretary Darman. It was not easy to reach a consensus. Then, help came again from Shultz. In his lecture delivered at Princeton in April, Shultz elucidated the need to rearrange the structural imbalance between U.S. and Japan, while avoiding currency intervention and the "locomotive strategy."

He diagnosed Japan's excess savings and the U.S.'s under savings as the fundamental cause of the U.S.-Japan structural imbalance. This imbalance created massive capital flows from Japan to the U.S. where interest rates were higher, raising the value of the dollar. So, he urged the removal of structural barriers to increase investment and consumption in Japan. Although Shultz's original proposal sought a structural change that should take a long time, Baker used this logic as a base for requesting that Japan increase investment and consumption through expansionary macroeconomic policies. Shultz's lecture served quickly to calm critical sentiment within the administration about the "Japan-German locomotive strategy." Thus, it paved the way for international fiscal coordination initiated by the Plaza accord which required Japan and Germany to expand their fiscal expenditure, notwithstanding Shultz's original intention.

In the following period up to September, bureaucratic level meetings were held frequently among G-5 countries. Germany initially opposed the U.S. proposal, claiming that global external imbalances were essentially due to the large U.S. budget deficit and to the severely strained U.S.-Japan relationship, and that Europe should not be obliged to bear the cost of correcting it. Finally, however, European countries were put in a position to agree. On September 22, the Plaza accord were announced which read "an orderly further appreciation of non-dollar currencies are desirable." This is the first time that a G-5 meeting announced a communique. Prior to this, not even the existence of G-5 meetings was officially acknowledged.

Although it was not made public, a 10-12% fall in the dollar was envisaged as desirable by the people involved. The communique did not use the word "intervention." During the meeting, the need to change monetary policy was not discussed at all. The dollar exchange rate fell by 4% immediately and continued to fall steadily after that by the rate which had been continued since February. The percentage of the fall in the dollar during the six months after the Plaza accord was the same with that of the preceding six months. The fall in the dollar was a natural course of events, yet it was generally recognized as a great achievement by Baker, bringing the U.S. a tremendous profit.

IV. Further Pursuit of International Policy Coordination

From the first quarter of 1985 to the first quarter of 1987, the average real trade-weighted value of the dollar fell 36%, which reversed 80% of its rise from 1979 to its peak in 1985. It took another year for the corresponding adjustment in the trade balance to occur. Since then, however, the U.S. trade deficit quickly shrunk. From mid 1986 to mid 1988, U.S. real export increased by 35% and the real trade deficit decreased by 40%. Were there no further political
intervention into the market, a further 10-15% fall in the dollar should have occurred which would have wiped out the U.S. trade deficit by the end of the 1980s. Yet, again, politicians could not wait for natural market adjustment to take effect.

Encouraged by the apparent success of the currency adjustments by the Plaza accord, Baker urged upon U.S. trade partners, particularly Japan and Germany, further monetary and fiscal expansions. Baker had a more compelling political reason to do so than other Finance Ministers. In order to ease the repayment burden on LDC's of their excessive debts based on the Baker plan, as well as to shore up a declining U.S. economy, he faced strong political pressure to reduce interest rates. Responding to the forceful pleas of Baker, Japan reduced its discount rate five times from 5% to 2.5%, each time by 0.5% in just over a year from the Plaza accord to the Louver accord.

The first reduction was from 5% to 4.5% in January 1986. This was reluctantly and unilaterally made by the Bank of Japan in response to the powerful overtures from Finance Minister Takeshita who was faced with domestic, as well as foreign pressure, to reduce interest rates. He was instructed to do so by Prime Minister Yasuhiro Nakasone who made coordination with the U.S. a basic policy of his administration.

The second reduction, which was made in March 1986, was the first coordinated reduction among four countries including the U.S., Japan, Germany, and France. At this time, the FRB seriously considered reducing its interest rate unilaterally because of the recession in the U.S. Volcker strongly opposed such a unilateral reduction, for fear that the value of the dollar would fall. He thus remained adamant at the Board of Governors meeting, and persuaded other countries to achieve coordinated interest rate reductions.5

The third reduction in April took place when the value of the yen was rapidly appreciating and a pessimistic prediction of the business activity was overwhelming. Baker strongly recommended this reduction to Minister of Finance Takeshita at a personal and unofficial bilateral meeting on the occasion of the G-5 meeting as did Volcker to the BOJ Governor Sumita. The Nakasone administration hoped for a positive political impact on the Tokyo summit meeting by showing close, cooperative relationship between the U.S. and Japan. Along with this political leadership, the third reduction was put into effect as a U.S.-Japan bilateral cooperative reduction of the discount rates just before the Tokyo summit meeting in May.

The fourth reduction was made based on the Baker-Miyazawa accord which grew out of their secret meeting on 6 September 1986. By that time, the yen had rapidly appreciated from its low of 260 yen/dollar to 154 yen/dollar. Japan’s new Finance Minister Miyazawa, who was afraid of its negative impact on export industry profits and business activity, secretly visited Baker in Washington. At the meeting, Miyazawa appealed to Baker not to seek further reductions in the value of the dollar and to try to maintain the current level of the exchange rate. In return, he proposed that Japan was willing to undertake a fiscal stimulus. Despite Baker’s pressure, Miyazawa was reluctant to make any commitment to a discount rate reduction, expressing his concern about soaring land prices in the Tokyo metropolitan area. Yet, Miyazawa gave Baker permission to tell Germany that Japan would be ready in coordination to lower its discount rate. Then, Baker used it as a tactic to negotiate with Germany to do the same thing, taking advantage of the bilateral negotiation.

5 Volcker’s fight with other members of the Board regarding this issue is referred to as the “Palace coup.” See Greider (1987) for the detailed story.
At the occasion of the G-5 meeting later in the same month, Baker and Volcker personally and unofficially met with Miyazawa and Sumita respectively. Again, they both strongly requested Japan's interest rate reduction in order to solicit Germany to do the same thing. Governor Sumita needed help from the MOF to obtain an internal consensus in the BOJ for a further reduction in the discount rate. Both Finance Minister Miyazawa and Vice Minister Yoshino strongly urged the BOJ to do so unambiguously. Formally, the decision regarding the discount rate rests solely with the BOJ. In reality, however, the MOF always took the leadership. The BOJ was simply put in a position to decide whether or not they would accept the assertion of the MOF that the discount rate cut was the only way to prevent the yen from appreciating. After all these negotiations, the fourth discount rate cut was announced by the BOJ on the same day as the Baker-Miyazawa joint communiqué on October 31, 1986.

The fifth and last discount rate reduction was made on the day before the Louvre G-5 meeting. Even after the Baker-Miyazawa communiqué in October, the yen kept appreciating further. Nevertheless, Baker continued “talk down the dollar” without taking any clear measures to resist the rising yen. He used the agreement with Japan as a lever to force Germany to further ease their monetary policy. Miyazawa, who clearly realized the limitations of bilateral negotiation, visited Baker again in Washington in January 1987 as instructed by Prime Minister Nakasone. At that time, Miyazawa stressed to Baker that a multilateral confirmation of a stable dollar needed to be agreed upon at a G-5 meeting. He also expressed that Japan was ready to reduce its discount rate unilaterally.

Baker was not so enthusiastic to have another G-5 meeting for this purpose. After a series of negotiations, he finally and rather reluctantly agreed to schedule it in February. The Japanese government intended to use its discount rate cut as a device to obtain the maximum effect out of the G-5 meeting. Thus, the fifth reduction of the discount rate was announced on the day before the Louvre G-5 meeting as a “gift” from the Japanese government whose supreme political imperative was to stop the rising yen.

V. The Louvre Accord

The Louvre G-5 meeting, held under these circumstances, was designed essentially to confirm the Baker-Miyazawa accord of October 1986. Germany and European countries had consistently stood against the setting of a target range for exchange rates. A reason why they agreed to participate in the Louvre meeting was said that they worried about bilateral coordination between Japan and the U.S. and hoped not to be left out from something of international importance.

The essential point of the discussion was how to define “around the current levels” that should be stabilized. Miyazawa was under strong domestic political pressure and insisted desperately upon the 150 yen/dollar line. European countries opposed to set any specific exchange rate level, maintaining that it should be left to market forces. Backer suggested 140 yen/dollar as the upper limit. Eventually, they made a strictly confidential agreement that specified levels as follows: 153.5 yen/dollar and 1.825 deutsche marks/dollar ±2.5% as the first line of defense for mutual intervention on voluntary basis, and ±5% as the level obliging consultation on policy adjustment, provisionally up until the next Washington G-7 meeting in April 6.
Following the Louvre meeting, the BOJ conducted market operations amounting to $16 billion during the first quarter of 1987. The FRB reversed its policy by raising the federal funds rate from February and coordinated with the BOJ and European central banks to buy dollars against yen totaling $3 billion from March 23 to April 6. Nevertheless, the dollar's value continued to fall. Therefore, at the G-7 meeting on April 6, the definition of "around the current levels" was forced to change to 146 yen/dollar. Europeans claimed that the yen deserved to appreciate more than the deutsche mark. They cautioned that the futile effort to spend huge amounts of money to get the yen back to the level of Louvre would lead to the loss of all credibility with the market. Miyazawa had no choice but to accept that new level, assured by others that 150 yen/dollar was still within the ±5% range.

Faced with the continued fall of the dollar, G-7 countries actively intervened in the market, recognizing the need to prevent a further plunge in the dollar. The U.S. intervention totaled $5 billion during the first four months in 1987. Germany intervened only to the amount of $750 million during the three months after the Louvre accord. This was less than other European countries. This resulted in part because the value of the deutsche mark to the dollar remained at the same level agreed upon in the Louvre accord, and partly because Germany worried about the negative impact on inflation of increased dollar reserves. In addition, the Bundesbank did not have enough yen reserves to sell in the currency market. Then, the BOJ offered to provide the Bundesbank yen for their intervention in exchange for SDRS and asked for their intervention on a larger scale.

European central banks intervened into the market not only because of the Louvre accord, but also because they took advantage of the relative strength of their currencies to replenish their foreign reserves by buying dollar assets voluntarily. Central banks bought about $140 billion dollar-denominated assets in 1987. In addition to market intervention by the BOJ, the Japanese government instructed large Japanese organizational investors, through "administrative guidance", to purchase U.S. bonds. In 1987 alone, therefore, Japan bought $100 billion in U.S. securities, which was equivalent to the annual U.S. current account deficit. In the case of Japan, due to the continuing rise in the yen, an enormous amount of exchange rate loss was expected. Nevertheless, a MOF official explained that "Japanese government did not mind the expectation of losing money since it would be cheaper than the cost of unemployment benefits and lost tax revenue that would result if the dollar were allowed to continue falling, thus weakening the ability of Japan to compete. Supporting the dollar would give Japanese industry time to develop new ways to be competitive at the higher yen-dollar rate that they knew was coming." Notwithstanding this support, the dollar fell to 137.25 yen/dollar in late April and continued to fall further for several months.

VI. Black Monday

Under these circumstances, people started to worry about the possibility of the dollar's plunge. The first symptom was the fall in demand for U.S. bonds resulting from a portfolio shift by nervous foreign investors and an accompanying abrupt drop in bond prices and a rise in interest rates in the Spring of 1987. The second symptom was the stock market crash on

\[^6\text{See Feldstein (1994b), p.73.}\]
October 19, 1987 known as Black Monday.

Despite efforts to stop the falling dollar, the U.S. trade deficit did not improve by the autumn of 1987. Baker was just about to urge Japan and Germany to implement their further expansionary policy once again. From late September towards mid October, Japan and Germany started to guide market interest rates upwards to curb possible inflation. They were also trying to determine the timing of a shift to a tight money policy. Short-term interest rates rose in Japan and Germany and the U.S. federal funds rate rose as well. The market started to expect a change to a tight money policy. Because of these factors, stock prices on the New York Stock Exchange had already fallen by 400 points during the two weeks preceding October 19. On October 15, stock prices dropped by the then-record 95 points, reacting to the unexpectedly large August trade deficit announced the previous day. On October 18, Baker again telephoned the German Finance Minister, Stoltenberg, urging him to undertake an expansion. The following day, stock market prices plunged 508 points.

Three reasons were pointed out as the principal causes for such a stock market plunge. The first was the announcement of an unexpectedly large trade deficit. The second reason was Germany's public refusal to adopt an expansionary policy, despite Baker's threat that the U.S. would allow the dollar to depreciate if Germany did not agree. The third reason was the market's fear that the FRB might raise interest rates in order to prevent the dollar from dropping below the level set by the Louvre accord.

Because of the frequently repeated theme of international policy coordination, the public had the impression that U.S. economic performance depended greatly on the policies of other countries and that the U.S. economy would be seriously damaged if other countries did not cooperate to protect U.S. interests. The public recognition of Germany's unwillingness to cooperate with U.S. policy was clearly an important contributing factor to the stock market crash. The third reason, the expectation of the FRB's change to a tight money policy, had a rational base. The FRB, which did not dare to deny the expectation of interest rate rises, changed the fundamentals, leading to the 400 point drop in stock prices two weeks immediately before October 19. The 508 point fall in the stock prices on October 19 is now regarded as a reflection of a panic, since, in retrospect, there were no serious consequences. The tighter money policy during the two weeks preceding the stock market crash led the market to realize that stock prices were above the level consistent with fundamentals and facilitated a return to a normal level by the 400 point drop.

Responding to the stock market crash, the FRB immediately announced the unconditional supply of additional liquidity needed in order to safeguard the economic and financial system. On October 20, it supplied $17 billion to the banking system. This was equivalent to 25% of the total bank reserves and 7% of the monetary base. At the same time, the FRB asked commercial banks to continue to lend to security dealers and brokers so that they could maintain their security stocks. Although violent oscillations continued in stock prices until the end of 1987, the FRB's quick response changed the mood of the financial market from uncontrolled panic to nervousness by as early as October 24 and created a climate for renewed market stabilization. As the situation calmed down and liquidity demand subsided, the FRB recovered most of the high-powered money injected on October 20. In order to avoid additional turbulence in financial markets, it kept the federal fund rate stable at a level 1% lower than its level just before the crash.

The effect of the stock price decline on the economy was projected by CEA to be about
one percentage point fall in real GNP growth during the following three to four quarters, which was rather small. With the expected contribution of increased exports, the real GNP growth rate was forecasted at 2.4%, a rather desirable slowdown from the rapid growth in 1987. In order to minimize the damage from the stock price decline and to achieve these projected favorable results, the CEA and the U.S. administration as well, thought that a prevention of a further sharp drop in stock and bond prices and an adequately easy monetary policy were critical and indispensable. The FRB did not reduce interest rates in order to avoid the risk of instigating an international financial crisis, because such a move could have been interpreted as an explicit attempt to drive down the dollar. The still non-improving U.S. trade deficit and the U.S. laissez-faire attitude towards the exchange rate, contributed to a further decline of 8% in the dollar's value by the end of 1987.

At this point in time, the U.S. urged more forcefully that Japan and Germany, who were just about to turn to a tight money policy, continue their easy money policies in order to avoid a drop in the dollar, as well as in U.S. bond and stock prices, the so called “triple plunge.” The U.S. strongly warned Japan that an increase in Japan’s interest rates could trigger a triple plunge, leading to a worldwide great depression, a renewed nightmare of 1930s. Faced with this ardent request, the BOJ decided not to change to a tight money policy in the autumn of 1987. In retrospect, had the BOJ turned to a tight money policy at that time, the worst part of the speculative bubbles in stock prices in Japan would have been avoided. The discount rate raise by the BOJ was not made until as late as late May 1989, nineteen months after Black Monday. This long delay in changing monetary policy brought about tremendous inflation in stock prices in Japan.

After the intervention by many countries in January 1988, the dollar started to appreciate in mid 1988 and continued until the presidential election in November. Since the yen/dollar exchange rate stabilized during the whole of 1988, there were many opportunities for Japan to turn to a tight money policy during 1988. At this time, however, an introduction of the excise tax in April 1989 became the most important political target of the Japanese government. Faced with this strong opposition by the government, the BOJ were not allowed to make a decision to turn to a tight money policy before the implementation of the excise tax, under the existing Bank of Japan law which gives a finance minister a legal power to guide and supervise the Bank of Japan. This long delay in raising the discount rate was not easy to understand for outsiders including the U.S. Thus, Japan’s policy, which kept the discount rate low, gave rise to even such an unrealistic interpretation that Japan was supporting the Republican presidential candidacy of George Bush instead of the Democratic party candidate (Michel Dukakis) who advocated protectionism, in supporting the appreciation of the dollar.

On the contrary, in spite of the U.S. opposition, Germany turned to a quick and severe tight money policy in mid 1988 in response to increasing signs of inflation. Germany raised its discount rate successively from the first half level in 1988, 2.5%, up to 8.7% in July 1992. Because of this long-lasting tight money policy, Germany succeeded in curbing major inflation. In distinct contrast, Japan’s discount rate increase was delayed as late as one year after the dollar’s upward trend became clear in mid 1988. (See Figs. 4 and 5.)

The target range of the dollar which G-7 countries agreed to as a point of intervention in early 1988 was 120–140 yen/dollar and 1.7–1.9 deutsche mark/dollar. The coordination effort of G-7 countries to stabilize the dollar, however, made the dollar appreciate to 150yen/dollar by mid 1989 which was far removed from its equilibrium level. This led to a renewed U.S.
trade deficit increase which had been improving. At the G-7 meeting in autumn 1989, the goal of dollar depreciation was agreed upon again and interventions were made. By the end of 1990, however, the yen depreciated by 15% from the level of the Louvre accord, increasing the U.S. trade deficit and aggravating U.S.-Japan trade friction.
VII. Fallacy of International Policy Coordination

A typical example of international policy coordination in the late 1980s pursued under the leadership of Treasury Secretary Baker was the system of “objective indicators” introduced despite the initial opposition at the Tokyo summit by the U.S. Its goal was to set target values for several macroeconomic indicators, including the GNP growth rate, the interest rate, the inflation rate, the unemployment rate, the ratio of budget deficit to GNP, the current account and trade balances, the money growth rate, international reserve holdings, etc., in addition to exchange rates. At each meeting, the performance of each country was to be checked based on the target values. This was a mutual surveillance system in order to achieve agreed upon objectives.

European countries, led by Germany, opposed this idea, asserting that it was a devised system allowing the U.S. to pressure other countries to expand their economies as a means to reduce the U.S. trade deficit, without undertaking the painful process of budget deficit reduction. Baker’s reaction to this argument went something like this: “We would prefer that you expand your economies and thereby import more from us so that reduction of the U.S. deficit can be achieved in a way consistent with growth for all parties. But, if you are not willing to go along, then I am afraid we are just going to have to let the dollar depreciate more, in which case your exports to us will fall.”

This argument for the expansionary macroeconomic policy of each country overly emphasized the international mutual dependence and the contribution of one country’s business expansion to the GDP growth of another. In reality, the mutual dependence among the U.S., Japan and Europe is impacted only to the extent of the effects of trade, which can easily be achieved or offset by domestic monetary and fiscal policy. International policy coordination discussions among finance ministers of G-7 countries diverted attention from necessary domestic economic policies. It also gave domestic voters the illusion that coordination by governments of developed countries could lead to higher economic growth with stable prices and a stable international trade environment.

The argument that the economic performance of one’s own country depends on the behavior of another country gave a convenient reason to blame other countries for not keeping their commitment when some problems arose in one’s own country. As a result, international policy coordination actually led to increased tensions among participating countries. For the policy coordination to achieve a certain level of exchange rates, domestic policy objectives have to be sacrificed. Though the rise in the U.S. interest rate in 1987 was intended to prevent the dollar from falling further, it became an important factor in creating Black Monday. The most prominent example is the prolonged easy money policy in Japan intended to prevent the yen from appreciating, which in turn created massive speculative bubbles and large scale inflation in stock prices.

As can be easily seen from this fact, coordinated intervention failed to achieve a specific level of exchange rate. For example, the agreed target zone for intervention was around 160

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yen/dollar at the time of the Baker-Miyazawa meeting in 1986, 150 yen/dollar at the time of the Louvre accord, 140 yen/dollar in April 1987, and 120–140 yen/dollar in the beginning of 1988. It was destined to be adjusted to the market trend. After all, setting a target at any level was done to attain stability of exchange rates, regardless of the specific level. Moreover, with no criteria for judging achievement, even "stability" is not a defined concept. Because of unclear and vague objectives, which were not attainable anyway, governments of developed countries repeated futile discussions and conflicts for a prolonged period in the late 1980s. As a natural consequence, depending on what degree each country diverted from its own legitimate domestic economic policy, the economic performance of each country was damaged.

**VIII. Central Bank Independence**

International policy coordination regarding exchange rate levels was made among finance ministers of each country without consultation with central banks. Nor did finance ministers make any official commitment about their monetary policy. Policy coordination talks on the monetary policy were made individually and unofficially. Based on the foregoing, it is evident that the independence of the Bank of Japan was the weakest among G-7 countries.\(^8\)

**A: Bundesbank**

The central bank demonstrated the staunchest independence was, needless to say, the German Bundesbank. Since Germany was consistently critical of international policy coordination, Baker's effort were focused on how to get Germany to join in with the coordination framework. The results of bilateral discussions with Japan were used as bargaining ploys for this purpose. The resolute independence of the Bundesbank from any political pressure is undoubtedly based on constitutional guarantees and freedom from supervision by any other governmental organization. The Bonn government's recognition that it could not influence the Bundesbank essentially put them in the negotiating position of having no room for compromise. Moreover, German stubbornness caused other participating countries to avoid making any strong commitment, because the burden would have to be shared unequally among the remaining participants. For example, when the U.S. asked Japan and Germany to reduce their discount rates in the Summer of 1986, the governor of the BOJ, Sumita, came to know that Germany would refuse so he also refused in cooperation with Germany, which is exceptional behavior by the BOJ.

The Bundesbank presents itself with a pride that it is the anchor of the world financial system. It also makes its position clear that it and the German government have nothing to do with the exchange rate, and this is well understood by industry. Accordingly, broad recognition and acceptance of these premises by both the lay public and politicians are essential factors supporting the independence of the German Bundesbank.

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\(^8\) This is consistent with the "ranking of central banks by overall legal independence during 1980s" by Cukierman (1992), p.382.
B: Federal Reserve Board

In the U.S., the FRB holds a considerably strong statutory independence. Although the president nominates the chairman and the members of the board, there are no official channels for the administration to exert its influence over the FRB, which reports to congress. In reality, however, the influence of the president and the administration is substantial. The ability to cope with these political influences depends heavily on the personal and professional capabilities of the chairman. Chairman Volcker, for example, demonstrated strong leadership and independence in the process of reducing inflation in the early 1980s. Even in his case, however, he reluctantly implemented consumer credit control in April 1980 at the insistence of President Carter, which resulted in complete failure. The strong leadership he displayed in the early 1980s relied greatly on the support of President Reagan who understood the importance of central bank independence.

Even though Volcker enjoyed an excellent reputation for his contribution in the fight against inflation, he joined Baker in demanding that Japan and Germany ease their monetary policies as part of a strategy in the late 1980s for international policy coordination. For the BOJ, Volcker was a symbol of independence, and his voice carried great weight. His behavior could be understood as an effort to protect the independence of the FRB by sacrificing the central bank independence of other countries. This episode undermined his once fabled worldwide reputation as chairman of the FRB. Judging from his first reactions to the idea of international policy coordination, he seemed to have been heavily influenced by pressure from Baker. All of this clearly illustrates the insufficiency of mere statutory independence of an organization. For real independence, the central bank must be unflinching in its attitudes and free from politics, and it must benefit from insightful understanding from the top of the administration.

C: The Bank of Japan

Compared with the U.S. and Germany, the weakness of the BOJ's independence is outstanding. As understood easily from the episodes involving five successive reductions of the discount rate, the BOJ was unwillingly forced to comply with the wishes of the political leadership of the administration, through the instructions of the finance minister. Undoubtedly, this is attributable to its lack of statutory independence since the BOJ is legally under the control of the MOF. In this regard, the revision of the Bank of Japan law to secure its organizational independence is an important issue to be resolved quickly. This is not enough, however. Even with statutory organizational independence, how could the BOJ have resisted pressure from its own government, as well as from outside, in a political environment in which stopping yen appreciation was the prime political imperative of the country? The independent judgment of the BOJ cannot be made completely independent from domestic and international, political and economic environment.

For instance, the substantial delay by the BOJ to change to a tight money policy originally planned in the autumn of 1987 was largely influenced by strong opposition from the U.S., coupled with a failure by the BOJ to recognize the threat of inflation. The official explanation by the BOJ of its failure to recognize the danger of the continuing inflation in asset prices should be interpreted correctly, in light of this background for the decision. Regardless of how influential the U.S. demand might have been, it was ultimately the BOJ’s decision how to conduct monetary policy. It can never blame the U.S. for its request, which the BOJ decided
on its own to accept. The only explanation that the BOJ can use is its failure to recognize the danger of inflation. It seems difficult to understand the reasons why the BOJ kept so seemingly unconcerned about the extraordinary growth of money supply and soaring land prices in Tokyo. Concern was even expressed by Miyazawa in his meeting with Baker in as early as September 1986, without taking the international political environment into account.

The Nakasone administration was in power when the international policy coordination was pursued based its foreign policy on close cooperation with the U.S., which was known as "Ron-Yasu relationship." Trade friction between the U.S. and Japan emerging at that time demanded a solution as a first national priority. It would be misleading to consider BOJ independence at that time in an abstract context without taking into account the compelling political sentiment resulting from threats by the U.S. Congress for protectionism, managed trade, and sanctions pursuant to the super -301 clause. In retrospect, however, if the exchange rate adjustment had been left to the market, these problems would have been resolved more quickly than it seemed at the time. The economic damage to the world caused by international policy coordination, especially to Japan, must be carefully evaluated to learn lessons from the past.

IX. Monetary Policy Based on a Rule

Although the idea of protectionism in the U.S. congress and the international policy coordination strategy in the administration gained considerable influence, quite a number of people within the administration were opposed, such as Secretary of State Shultz and Chairman Feldstein of the CEA. They argued that the U.S. trade deficit was attributable to a lack of U.S. savings and its macroeconomic policy, and not to unfair trade practices by foreign countries. This logic was largely accepted by economists, especially in academia.

Since Baker became the Treasury Secretary, however, this legitimate theory quickly lost its political influence. During this time, some academic economists argued for international policy coordination using unrealistic models, while others looked upon the international policy coordination clamor coolly as a political game. It was unfortunate that the Japanese administration, which was eager to cooperate with the U.S., failed to evaluate the cool-headed view correctly and did not work more closely with Germany. With Japan being under U.S. military protection, it is doubtful that Japan can refuse a U.S. request, especially when the issue becomes a political imperative for the U.S.

Consequently, led by a powerful politician, Baker, a policy which lacked any legitimate theoretical background and contradicted basic market principle was pursued in order to protect U.S. national interests. This course of action negatively impacted the economic policies of participating countries and infringed upon the independence of their monetary policy. Despite statutory and organizational independence, these sorts of problems will continue to happen, as has occurred repeatedly in the past. The only way to avoid a repetition of this problem is to clearly demonstrate that Japan's monetary policy is politically inviolable, much like the constitutionally guaranteed independence of the Bundesbank.

The strong independence of the Bundesbank comes not only from its statutory guarantee, but also from its internationally known policy objective of preventing inflation demonstrated by the long-lasting, consistent behavior of the bank. This is the rule in conducting monetary
policy in Germany. Such a clearly defined policy may well bind a central bank’s hands in terms of arbitrary choices, however, it also binds the hands of politicians who would understand that arbitrary policy choice is impossible. As long as a central bank has room for arbitrary policy choice, it is inevitable to receive political pressures that could infringe its independence each time some economic problem arises. The only way for a central bank to stand against these pressures is to unambiguously establish a policy rule that focuses only on its prime goal. Then, it must demonstrate it domestically and internationally and acquire public confidence through a process of consistent actual decisions.

Once a policy rule, which by definition is not easily changed, is established, private economic agents are able to more easily undertake long-run economic activities systematically with rationally formed expectations about the future economic environment, taking the policy rule into account. For example, the money supply targeting rule introduced by Volcker to fight U.S. double digit inflation in the early 1980s worked. While this new rule bound the hands of the FRB itself, it clearly showed the determination of the FRB to fight inflation and how it was going to do it, which contributed to reducing inflationary expectations.

Specifically speaking, the establishment of central bank independence is nothing other than confirmation of its prime objective to prevent inflation. This means that other economic objectives, including employment, growth and exchange rate levels have to be sacrificed, if necessary. At this point, political pressure comes into the picture, and that could infringe upon the achievement of the prime objective in the long-run. “Preventing inflation at any cost” has a far more clear meaning than the practically same but vague terminology of central bank independence.

The policy rule that should be established for preventing inflation need not be a strict k% money supply rule. A policy rule that defines its prime objective as prevention of inflation could encompass wider alternatives. The consistent behavior of the Bundesbank, the goal of which everybody understands to be prevention of inflation, is the typical example of a policy rule we have in mind. The most practical way to establish independence is to set a policy rule which specifies its prime objective as prevention of inflation. This firmly established behavioral rule reduces the room for arbitrary policy choices to use monetary policy for other purposes. And we know that inflation can be prevented by controlling the money growth rate over a certain period of time.

There may be an objection to this recommendation; adjusting the level of business activity will be lost if there is no room for arbitrary policy decisions. However, any possible welfare gains to be obtained by removing small fluctuations around a growth trend by the ideal operation of discretionary monetary policy is by far of a smaller magnitude compared to the huge welfare losses caused by a poorly executed discretionary monetary policy, such as happened in Japan in the early 1970s and again in the mid 1980s. Moreover, the effect of discretionary monetary policies is not guaranteed; historically, they often caused large fluctuations later.

As pointed out by Irving Fisher, the main cause of all great depressions is the preceding easy money. Everybody likes easy money. Whenever some economic difficulty breaks out,
political demand for easy money is created claiming that this is an historically unprecedented
difficulty. A central bank that accommodates this demand will always plant seeds for a future
great depression. The idea of a monetary policy based on a rule is an intangible asset created
by human wisdom based on repeated, similar experiences in the past.

X. What is a Policy Rule?

It should be worthwhile now to note the difference between rules and discretion. Mussa,
a member of the CEA in the 1980s, claims that in practice they are identical.\footnote{See Mussa (1994), p. 138–141.} In the sense that
even discretionary decisions are made based on past experiences and all kinds of data from
different sources intending to achieve the desired results, and are not being made whimsically
and haphazardly by policy makers, discretionary decisions can be regarded as subject to
certain kinds of rules as well. The critical difference between the two, however, is whether the
public knows the decision rule of the authority in advance and whether they can correctly
predict the authority’s behavior. The point is not just how policy makers make policy, but more
importantly, whether the public knows it so that they can use the knowledge to predict the
future behavior of the authority. Rules have to be simple for broad public understanding.
Complex, conditional rules prepared to meet all conceivable contingencies do not work well as
rules and are no different from discretionary policy.

If the public knows the behavioral rule of the authority, each economic agent, upon facing
various economic changes, can better adjust its behavior to maximize utility under new
conditions, based on its prediction of the future economic environment. This is the essence of
a market adjustment mechanism that brings about economic stability to various shocks in the
economy. In this sense, the money supply rule is easy to understand and thus a typical example
of a policy rule. Notably, the strict attitude of the Bundesbank towards inflation can be
regarded as a policy rule which is well understood by the public.

Looking at the U.S. experience, by announcing a new policy operating procedure in 1979
to use a predetermined money growth rate as the target, the FRB made a commitment to
restrict its own policy choices. By showing the rule to fight inflation to the public, it became
a major factor contributing to the reduction of inflationary expectations. To set rules which
officially restrict one’s own behavior is a very important measure to facilitate understanding of
an authority’s behavior and to make economic forecasting by the public easier.

Conclusion

In many countries there is a trend towards establishing central bank independence. This
is partly because central banks of Europe are obliged to satisfy this condition if they hope to
join the EMU, and partly because its importance was reaffirmed by the experience of the
speculative bubbles in the 1980s. Already in New Zealand, Argentina, Chile and South Africa,
constitutional independence from the executive branch of government has been established, in
similar fashion to Germany and Switzerland. These countries suffered from high inflation and low growth in the past, now they enjoy the highest economic performance of their regions. For Japan, whose central bank legal independence is ranked almost at the bottom and who still is suffering from the aftermath of the world's worst speculative bubbles, the establishment of central bank independence has a crucial importance.

Once established, however, it is only of secondary importance. The German Reichsbank was responsible for disastrous hyper-inflation in 1920 which triggered a miserable chapter in Germany's history; actually, it was statutorily independent from the executive branch of government. Even the FRB, which has much stronger statutory independence than the BOJ, is not immune from influence by the executive branch of its own government. In the case of Japan, international policy coordination, which had a big impact on monetary policy, had nothing to do with statutory independence.

Politicians are destined to be susceptible to public opinion and tend to have shorter time-horizons than needed for sound economic policy. In the case of easy money, the effect of lowering interest rates is immediately welcomed by the public, while negative effects like inflation appear much later. In the case of tight money, on the contrary, the negative effects on public opinion of higher interest rates appear immediately, while the positive effect of increasing public welfare can be realized only after a long period of time or may often not be recognized at all. For these reasons, political pressure for an easy money policy is always seen when economic problems emerge.

In so far as a central bank is also a branch of government, its decision cannot be independent from its country's political and economic environment. In most cases, the independent judgment of a central bank may coincide with the judgment of the executive branch of government. In this sense, public opinion exerts the more fundamental influence on policy priorities. Public opinion, however, is difficult to define clearly, easy to change and not immune from an intentional guidance. Faulting public opinion and politicians in general are often excuses for not having concrete ideas about solutions to problems. In order to acquire the understanding of the public and politicians, therefore, the presentation of a simple and clear principle regarding the policy priority and the procedure for its achievement is indispensable.

The presentation of a policy rule which binds the hands of a central bank and which cannot be easily changed would facilitate public understanding of the central bank's policy objective by narrowing the range of arbitrary policy choices. In order for the public to understand and have confidence in a policy rule, it must be established through consistent behavior of the central bank. Supportive public opinion would be gradually formed by the actual results of decisions taken by the central bank. The policy rule is an effective tool for maintaining organizational memory, which is easily lost through personnel changes, and for maintaining consistent behavioral criteria in the longer time horizon.

After all, the point of central bank independence is to give first priority to the objective of preventing inflation and to confirm a willingness to sacrifice employment in order to achieve the primary objective. Public consensus on this objective is the key to success which in turn

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13 See Goodhart (1995), Chapter 4.  
15 See Goodhart (1995), Chapter 4.  
comes from public confidence in the central bank which behaves with a longer-time horizon than politicians. The objective of preventing inflation is well received by the public immediately after an inflationary experience from which they have suffered. After some time without inflation, however, people easily forget the past experience and ask monetary policy to do more, creating pressure on central bank independence.

We must challenge ourselves to get rid of the surprisingly common illusion that once inflation is “subdued” and it is no longer a problem, we can use monetary policy freely to achieve other objectives. In any case, monetary policy is not a sure tool to achieve objectives other than preventing inflation. In the dead of winter, once the house is maintained at a comfortably warm temperature and the outside coldness is “subdued”, do we propose to cut off the furnace and use it for cooking?17

In this regard, it is the best time now, when people clearly remember the harms of inflation, to establish a policy rule and to define the purpose of monetary policy narrowly as only to prevent inflation, thus limiting over-expectations of certain pressure groups who would try to use monetary policy for other purposes. In other words, the core of central bank independence is the unflinching determination of the central bank itself to refuse the request to contribute to exchange rate adjustments or fine tuning of business activity. A statutory guarantee of independence is only an environmental arrangement for a central bank, enabling easier decision making consistent with this responsibility.

The process of the birth and burst of speculative bubbles which threaten the Japanese financial system contains rich lessons which should be learned. Efforts are needed now to draw lessons from this experience and to use them in reframing monetary policy conduct and reorganizing the central bank and financial system of Japan.

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