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A History of the Bank of Japan,
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1. Introduction

In this paper, we review the history of the Bank of Japan (BOJ) with a focus on the changing role of the central bank and the transformation of the national economy (Table 1). When Japan joined the modern world in the late 19th century as a country with a small and open economy, the Bank was created as an entity to integrate the national financial market and provide liquidity for economic growth. By the early 20th century, Japan had succeeded in joining the modern world and began pursuing its goal as an empire. Under this condition, the Bank played a pivotal role in financing wars and in stabilizing the less-disciplined national financial market. Yet during and after Japan's losing war with its main trading partners in the 1930s and 1940s, the Bank was overwhelmed by ballooning government debt and rampant post-war inflation. When Japan re-focused its national goal on high economic growth during the 1960s and early 1970s, the Bank was revived as an engine to fuel liquidity into the national economy even without legal independence. Once the Japanese economy reached an advanced stage of development from the 1970s onward, the Bank's main task changed from providing liquidity for economic growth to stabilizing the domestic economy. In pursuing its task, the Bank has often faced trade-offs between guns and butter, stability and growth, the threat of economic backlash and the moral hazard problem. The Bank has been and still is learning from new challenges.

Table 1. Chronology of Developments in Relation to the BOJ and Japanese economy

Year	BOJ	Year	Japanese economy
1882	BOJ established	1859	Opening of the treaty ports
1885	First BOJ notes (silver standard)	1868	Meiji Restoration
1897	Adoption of the gold standard	1894-1895	Sino-Japanese War
1917	Suspension of the gold standard	1904-1905	Russo-Japanese War
1930	Return to the gold standard	1914-1918	WWI
1931	Departure from the gold standard	1927	Showa Financial Crisis
1942	BOJ Act of 1942	1941-1945	WWII
1946	Emergency Financial Measures		
1949	Amendment of the BOJ Act		
1973	Move to flexible exchange rates	1960	National Income-Doubling Plan
		1973	First oil shock
		1985	Plaza Accord
		1987	Louvre Accord
1998	BOJ Act of 1998	1997-1998	Heisei Financial Crisis

Source: See text.

2. Entrance to the Modern World and Establishment of the Bank

2.1. The Monetary System in Japan during the Pre-Modern Periods (-1850s)

Japan has a long history of banking activities. During the Edo Era (1603-1867), a sophisticated market economy of sorts developed in Japan, an agrarian country that produced commodity crops widely throughout all of its territory. Taxes were levied by the *koku*, a unit of rice. Feudal lords shipped their rice to Osaka to sell to merchants in exchange for money to be used to finance their daily purchases. Seasonality in rice production forced the feudal lords to depend on commercial credits supplied by rich merchants at other times of the year. Among merchants, bills of exchange based on traded rice and claims on future rice tax to be collected by feudal lords were regarded as good collateral. Commodities from all over the country were sent to Osaka and then distributed to Edo and other sites of consumption. As commercial activities penetrated the countryside and the division of labor spread throughout the nation, some merchants began engaging in financial operations of various types. Though Japan had no formal banking system, moneychangers and other merchants formed inter-regional networks and engaged in wide-ranging banking activities such as deposit-taking, lending, bills of exchange, and the issuance of paper money. Moneychangers provided liquidity to the society and managed risks much in the same way as modern bankers¹.

2.1.1. National Currencies in the Pre-Modern Periods

From the late 7th century to the mid-10th century, the Japanese government minted copper coins modeled after Chinese ones. The coins circulated along with commodity money such as rice and cloth. A series of debasements, however, eroded credibility for the money issued by the state. In the mid-10th century, the government stopped minting on the grounds of shortages in the materials for coins, leaving commodities such as rice and cloth as Japan's only currencies².

From the 12th to 16th century, Chinese copper coins flowed into Japan and were widely circulated within the country. During the civil war period from the late 15th through the 16th century, warlords vigorously developed gold and silver mines and began using gold and silver as money, along with rice and imported copper coins. Silver became Japan's main export good from the late 16th to early 17th century. Warlords in the western part of Japan were especially active in mining, minting, and exporting silver. As a result, the money in large denominations circulated in western Japan was predominantly silver³.

Japan entered a period of peace and political unity in the early 17th century after the civil war from the late 15th century. Under the rule of the Tokugawa Shogunate in Edo (now Tokyo), some 300 feudal lords governed territories throughout Japan until the late 19th century.

The Shogunate promoted foreign trade during the early 17th century, but later expelled the

¹ Takatsuki (2017), pp.106-143; Iwahashi (2002), pp.459-466.

² Sakaehara (2002), pp.5-39.

³ Sakurai (2002), pp.42-55.

Portuguese and Spanish, imposed a ban on emigration by Japanese people, and set strict controls on foreign trade. The Shogunate pursued these policies mainly for political reasons to avoid the penetration of Christianity and to prevent potential alliances between foreign powers and the feudal lords. Only the Dutch and Chinese, who were seen as non-religious people, were officially allowed to trade with the government and its agents. Economic isolation made Japan a microcosm independent from the rest of the world until its treaty ports were forced open in the late 19th century⁴.

The national currency system in Japan during the Edo Era was characterized as a tri-metallic system consisting of gold, silver, and copper coin specie. The Shogunate promoted the use of gold coins as the national currency throughout the era, while allowing the use of silver and copper coins as domestic currency. Gold coins were a denominated currency based on a unit called the *ryo*, while silver coins were a currency denominated by weight based on a unit called the *monme* (the equivalent of 3.75 grams). Copper coins were a denominated currency based on the traditional unit of *mon*. The monetary units in use varied from one territory to another. The *monme* was widely used as a unit of account in the western part of Japan, including Osaka and Kyoto. The *ryo*, the gold unit, was used in the Eastern part, including Edo. The *mon*, the copper unit, was used in most regions for small-denomination transactions and in some regions for large-denomination transactions, as well. While the Shogunate took control of minting and set the official exchange rates for gold, silver, and copper/iron/brass coins, the market rates fluctuated daily based on the regional balance of payments as well as the supply and demand of real money. Along with these metal forms of money, feudal lords and merchants issued paper money (clan notes and private notes) denominated in the units of the above specie. The Shogunate held back from issuing paper money until the last years of its reign.⁵

2.1.2. Moneychangers as Financial Institutions

Money and financial institutions promoted nationwide commercial activities throughout the Edo Era. Various types of financial activities flourished and sophisticated methods such as commodity futures emerged.

The Shogunate allowed the feudal lords to levy taxes and police the subject people in the

⁴ Toby (1991).

⁵ Iwahashi (2002), pp. 431-451. After the collapse of the Tokugawa Shogunate in 1868, the new government surveyed currencies issued by the old regime that were still in circulation. According to the survey, an equivalent of 187 million-yen was in circulation. Out of this sum, 88 million yen, or 47 percent, was gold coins denominated in *ryo*; 67 million yen, or 36 percent, was silver coins denominated in *ryo* (subsidiary coins of gold); 6 million yen, or 3 percent, was copper/iron/brass coins denominated in *mon*; 2 million yen was silver coins denominated in *monme*; and 25 million yen, or 13 percent, was paper money denominated in various units. The Bank of Japan (1973), pp.152-153.

territories. Each lord was classified by the size of his territory based on the volume of its rice harvest in a unit called the *koku* (1 *koku* = 180 liters). In return, the feudal lords were required to live in Edo every other year to express their loyalty to the Shogun. Their wives and successors, meanwhile, were required to live in Edo permanently, as hostages in effect, to deter the lords from rebelling. This system of alternate attendance (*sankin koutai*) was formalized by the Acts for Military Houses (*Buke-Shohatto*) in 1635 and lasted until the final days of the Shogunate government in the late 19th century⁶.

The alternate attendance system promoted commercial activities and the use of money, forcing the feudal lords to monetize their economic activities. The lords needed to sell their products in order to cover the expenses they incurred during the stays in Edo and on the road between Edo and their territories. The regional division of labor among warriors and commoners, meanwhile, necessitated the exchange of goods and services across regions and classes of people. Osaka was a national commercial and financial center with a rice futures market.⁷

Moneychangers engaged in a wide range of banking activities beyond currency exchange, such as accepting deposits, lending, exchange bills, and issuing paper money. They originated as merchants of various forms and operated their original businesses concurrently with banking⁸.

Japan had no central bank during the Edo Era, and the national financial market was not yet integrated. Liquidity was channeled into the economy through correspondent networks of moneychangers. Groups of moneychangers in Osaka, Kyoto, and Edo formulated guilds as hubs for the national payment networks⁹. When the feudal lords issued clan notes, they often relied upon moneychangers with expertise in reserve management.

2.2. Reforms after the Opening of the Treaty Ports (1860s-1880s)

After the enforced opening of the treaty ports in the 1850s, Japan began to trade internationally on a major scale. Low tariffs under the unequal treaties with major western powers forced Japanese industries to compete with foreign counterparts. After the Meiji Restoration in 1868, the new government moved to establish modern monetary and financial systems with some trial and error. In the course of events, the government introduced a multiple issuing bank system based on the US model, then supplanted it with a European style of central banking system by establishing the BOJ.¹⁰

2.2.1. Debate on Banking Systems and Establishment of National Banks

In 1868, the government introduced the *dajoukan-satsu*, a new government note based on the

⁶ Hayami (1999), pp.22-23.

⁷ Miyamoto (1988); Schaede (1989).

⁸ Sakudou (1971), pp.105-544.

⁹ Iwahashi (2002), pp.459-464.

¹⁰ The description below is based on Shizume and Tsurumi (2016).

existing unit of account in gold (*ryo*), and abolished the use of the silver currency by weight. The *dajoukan-satsu*, the first paper money to be circulated nationwide, was initially introduced as a substitute for gold and silver coins issued under the rule of the Tokugawa Shogunate. The merchants used it as a means of payment for long-distant trades, and the feudal lords who still governed their territories used it as a reserve asset for local paper monies¹¹. Yet due to massive fiscal expenditure towards the civil war and shortage of fiscal revenues, the *dajoukan-satsu* was issued in excess, which resulted in inflation.

In 1869, merchants introduced the *kawase-kaisha*, prototypes of modern commercial banks, under the leadership of the government. *Kawase-kaisha* were established in eight trading centers: Tokyo, Osaka, Kyoto, Yokohama, Kobe, Niigata, Otsu, and Tsuruga. Their primary functions were usual banking activities such as accepting deposits, extending credit, and transferring funds over long distances. They were also authorized to issue banknotes. Very soon, however, bank runs forced all of the *kawase-kaisha* except one, that in Yokohama, out of business.

In 1870, Hirobumi Ito, a high-ranking official in the Ministry of Finance (MOF) who had been sent to the United States to study American monetary and banking systems, submitted a proposal recommending the establishment of a monetary and banking system based on the gold standard with multiple issuing banks¹². After exploring the American national banking system, Ito argued that Japan's issuing bank system should be modeled after the national banks in the United States. His reasoning was focused on the structure of the Japanese economy, which was decentralized at the time and more closely resembled the economy of the United States than it did the economies of Europe¹³.

In 1871, Kiyonari Yoshida, a MOF official who had just returned from a long stint in Europe and the United States to study their financial systems, proposed a plan for the establishment of a single issuing bank modeled after the Bank of England¹⁴. A sharp debate arose over the two competing plans for the new issuing bank system.

Ito argued: "If we introduce the U.S. system, we will be able to redeem half of the existing currency into banknotes issued by the newly established issuing companies and convert the other half into government bonds. In doing so, we will recover the credibility of the currency."¹⁵

Yoshida responded: "We should introduce the common method of banknote issuance in Europe by establishing an issuing company with specie reserves. By doing so, we will eventually be able to make coins and paper money convertible."

Ito criticized Yoshida's argument: "Your plan overlooks the nature of the government as an

¹¹ Kobayashi (2015), pp.323-326.

¹² The national banks in the United States were allowed to issue banknotes as privately-owned commercial banks operating under a national charter.

¹³ The Bank of Japan (1982), pp.16-18.

¹⁴ The Bank of Japan (1982), pp.18-19.

¹⁵ Shunpo-ko Tsuisho-kai (1940), p.527.

entity that can utilize the power of the private sector. It only considers the government's accounting with no thought for the progress of the people." ¹⁶

In a sense, Ito advocated an endogenous supply of money to promote industrial development based on the banking school approach. In contrast, Yoshida emphasized stabilization through the control of money based on the currency school approach.

In 1871, the government declared that it would adopt the gold standard and introduce the yen as the new unit of account. It also issued gold coins for general use and silver coins for international trade. A year later the government issued government notes denominated in yen and proclaimed the National Bank Act of 1872. Under the Act, national banks were allowed to both engage in the usual banking activities and issue convertible notes. The establishment of private banks authorized to issue convertible notes was a compromise between Ito's and Yoshida's arguments. By law, the amount of national banknotes could not exceed 100 million yen. This was effectively an unlimited allowance for banknote issuance, given that the value of notes in circulation (including those issued by the government and former feudal lords) was currently less than 100 million yen. Yet due to strict regulations, most notably a high reserve ratio, only four national banks were established under the National Bank Act of 1872.

2.2.2. The Amended National Bank Act of 1876

Under amendments to the National Bank Act in 1876, the government made national banknotes inconvertible and authorized national banks to issue banknotes backed by national bonds.

The change in banking policy was prompted by a need to cope with reforms in the stipend scheme for former samurai. After the collapse of the Tokugawa Shogunate, the government continued paying stipends to former samurai. Under fiscal reforms effected in 1876, the government stopped paying the former samurai stipends, offering coupon bonds instead. The purposes of the National Bank Act amendment were twofold: to appease the former samurai for their lost privileges by deregulating their investments through national banks, and to mobilize the capital the former samurai held as government bonds¹⁷. Under this arrangement, national bonds could serve as reserves for national banknote issuance. A large number of national bonds and national bank shares were floated as a result.

Ito's proposal was fully implemented at this stage. One hundred and fifty-three national banks were established from 1876 to 1879, including four re-chartered banks that had been established under the previous National Bank Act. Some banks were established by moneychangers. Others were established by merchants or former samurai¹⁸.

¹⁶ Ministry of Finance (1905), pp.25-26.

¹⁷ Ministry of Finance (1905), pp.112-113; The Bank of Japan (1982), pp.26-28; Shizume and Tsurumi (2016).

¹⁸ Asakura (1961).

In the same year, 1876, the government chartered Mitsui Bank to go into business as Japan's first privately-owned bank not designated as a national bank (*shiritsu ginko*). Many other privately-owned banks were established in ensuing years. Though chartered to engage in the usual banking business, these privately-owned banks were prohibited from issuing banknotes.

While the origins of the national and other privately-owned banks differed, the operations of both depended on the managerial skills of moneychangers. Many other moneychangers, meanwhile, remained in the banking business without government charters. The Meiji government called these moneychangers quasi-banks.

Table 2 shows the number of Japanese financial institutions recognized by the government in 1881, along with their capital. A total of 149 national banks, 90 other privately-owned banks, and 369 quasi-banks were recognized. Acknowledging that it was unable to acquire sufficient information about the quasi-banks, the government advised that the quasi-bank statistics were possibly underestimated.

On average, the quasi-banks were much smaller than the national and other privately-owned banks. The capital of the national banks, other privately-owned banks, and quasi-banks averaged 295 thousand yen, 116 thousand yen, and 16 thousand yen, respectively. Even after excluding the giant Fifteenth National Bank, which had been established with funds from the former feudal lords, the capital of the national banks averaged 176 thousand yen, a sum still far higher than that of the other types of financial institutions.

Table 2. Financial Institutions as of the end of 1881

	Number	Total Capital*	Average Capital*
National Banks	149	43,886	295
Excl. 15th Bank	148	26,060	176
Other privately-owned Banks	90	10,447	116
Quasi-banks	369+	5,895+	16
Total	608+	60,228+	n.a.

* thousand yen.

Source: *The Second National Statistical Abstract of the Japanese Empire*, 1884.

In response to the banking boom and in the face of rampant inflation during and after the Seinan Civil War of 1877, the government moved to regulate the supply of money. In the same year, Finance Minister Shigenobu Okuma proposed a cap on the banknote issuance amount by prefecture. In the next year, 1878, the National Bank Act was amended again to set an effective limit on banknote issuance. The government then introduced a regulation on the allowance of banknote issuance in each prefecture. When the total allowance for all prefectures reached a national limit of

34 million yen, the government stopped accepting requests for new bank establishments.

2.2.3. The Bank of Japan Act of 1882

After the Seinan Civil War of 1877, the government began to lean towards the establishment of a central bank as the sole issuer of convertible banknotes. In the initial phase, Finance Minister Shigenobu Okuma proposed issuing bonds in the international markets to build up specie for conversion of banknotes into specie. Another financial statesman, Masayoshi Matsukata, opposed Okuma's proposal, arguing that the issuance of foreign bonds would risk Japan's sovereignty if Japan had trouble repaying. Instead, Matsukata advocated an austerity policy towards the establishment of a central bank.¹⁹

In 1881, another political debate arose on the creation of a constitution. Okuma insisted on the establishment of a parliamentary system of government. Other members within the government, including Matsukata, attacked Okuma as too radical and ousted him from the ministry. The government, meanwhile, promised to formulate a constitution based on the more conservative Prussian constitution by 1890 and to hold a general election. Matsukata finally won a series of internal battles with Okuma and became Finance Minister in 1882. He led Japan's financial policy as Finance Minister, with some hiatuses, up to 1900, establishing the BOJ in 1882 and introducing austerity fiscal policies from the same year onwards.²⁰

When Matsukata was sent to the Paris International Exposition in 1878 as the Deputy Representative from Japan, he had another mission to study central bank systems in Europe. Initially intending to study the French system, he asked for the advice of the French Finance Minister, Léon Say. Say recommended the National Bank of Belgium (NBB) as a model for the central bank of Japan, as the bank had been recently founded (in 1850) and operated under laws and bylaws that were more clearly written than those for earlier banks such as the Bank of France. Following Say's advice, Matsukata and his subordinate studied the Belgian system extensively, as well as the system in France. The founders of the Japanese central bank and their predecessors had thus studied the monetary systems of at least Britain, France, and Belgium, as well as the United States, a nation without a central bank, before establishing the BOJ.

The NBB was a semi-public institution established to restore monetary and financial stability after a series of national financial crises. The legislation to establish it emphasized the convertibility of its banknotes and allowed liquidity provision only for short-term commercial liabilities. It operated as a private joint-stock company with commercial activities driven by the profit motive. At the same time, the NBB performed functions in the public interest such as the

¹⁹ The Bank of Japan (1982), pp.77-106.

²⁰ The Bank of Japan (1982), p.107.

issuance of banknotes and operations as a government cashier. The Belgian government appointed a governor and government commissioner to run and oversee the NBB²¹.

Although political and economic conditions in Japan differed from Belgium at the onset of the BOJ, the Bank inherited the legal and institutional settings of the NBB. The Bank of Japan Act of 1882 conferred the BOJ with the status of a semi-public institution. The bank's shares were to be owned by the private sector, and a governance mechanism was in place to ensure the Bank's accountability to shareholders. The government, meanwhile, was to appoint the governor and vice governor of the BOJ and keep the Bank's activities under its strict control. The Act stipulated that only Japanese citizens could hold shares of the Bank, and only with the permission of the Finance Minister (Articles 5 and 6). The bank was to engage in the businesses of 1) discounting and buying of commercial and government bills, 2) buying and selling of gold and silver, 3) lending backed by gold or silver as collateral, 4) collecting due amounts of funds of customers with contracts, 5) accepting deposits and keeping gold, silver, and other precious metals and securities in custody, and 6) lending with overdraft contracts or with fixed term contracts on securities issued or guaranteed by the government as collaterals subject to the interest rates permitted by Finance Minister (Article 11). The bank was to be the treasurer of the government (Article 13). The bank was given the right to issue convertible banknotes (Article 14). The bank was permitted to hold issued bills and checks (Article 15). The bank was permitted to buy and sell government securities subject to the permission of Finance Minister (Article 16). The governor of the Bank was to be appointed by the Emperor and the vice governor was to be appointed by the government (Article 18). Executive Directors were to be elected by the general shareholders' meeting and appointed by the Finance Minister. Auditors were to be elected by the general shareholders' meeting (Article 19). The government was to send a supervisor to the Bank's site (Article 21)²².

2.2.4. National Banks and the Central Bank (1880s-1890s)

At the founding of the BOJ, Matsukata declared that the central bank was to serve as the hub of Japan's national financial and payment system, pumping in liquidity just as a heart pumps blood to the human body. He claimed that Japan suffered from insufficient liquidity. He blamed the existing national banks for driving up interest rates and hampering the national financial integration by failing to adequately cooperate with each other or adjust inter-regional surpluses and deficits of funds.²³

The government sought to establish a financial system with a pyramid structure headed by the BOJ. It divested the national banks of their right to issue banknotes, granting that right instead to

²¹ Buyst and Maes (2008), p.161. They review the process and purpose of the establishment of the NBB and the operation of the NBB in its early days.

²² The Bank of Japan (1986), p.195.

²³ Matsukata (1882), p.992.

the BOJ alone. At the same time, it redeemed existing government notes in circulation.²⁴ The BOJ started issuing banknotes in 1885, just as Matsukata's austerity policy had reduced inflation. The first banknote issued by the BOJ was convertible to silver. Japan thus switched to the silver standard in the 1880s, dropping its initial plans to adopt the gold standard from the decade before. The silver dollar (the Mexican dollar) was widely circulated in the Asia-Pacific region, and silver coins issued by Japan from the 1870s were circulated both domestically and internationally. The transformation from Japan's multiple issuing bank system to a single issuing bank system, the conversion of the previous national banks into ordinary banks, was completed by 1899.

The BOJ, however, needed time to effectively perform its functions as the central bank. The operation of the BOJ in its early days was literally "learning by doing" in a number of dimensions.

The first dimension was smoothing of the seasonality in interest rates. In theory, a central bank empowered to issue its own banknotes would be able to adjust the seasonal fluctuations in the demand for liquidity, and thus to smooth the seasonality in interest rates. Fukuda (1995), however, finds that the interest rate seasonality persists until around the end of the 19th century even as the BOJ attempted to respond in an elastic manner from the issuance of its first banknote in 1885²⁵.

The second dimension was adjustment of inter-regional discrepancies in the supply and demand of liquidity. The founders of the BOJ initially expected that the correspondence network of the BOJ would work as a channel to provide liquidity nationwide. A preliminary analysis by Shizume (2017), however, shows that the correspondence network of the BOJ with other banks in the 1880s added little to the existing networks of the private banks. The BOJ built branches in the 1890s and had one headquarters and 10 branches by 1900. As Ohnuki (2007) and Mitchener and Ohnuki (2007, 2009) demonstrate, the national capital market was integrated over the long run.

The third dimension was crisis management and the BOJ's role as a lender of last resort (LoLR). Matsukata Masayoshi, the founder of the BOJ, mentioned nothing about this role as a LoLR when the Bank opened in 1882, even though he had stayed in Europe after Walter Bagehot published *Lombard Street* in 1873. The BOJ changed its stance toward the financial market for the first time after facing the banking panic of 1890 in Osaka and western Japan. The bank actively extended its lending operations by adding company stocks to eligible collaterals in ensuing years, paving the way to its LoLR function toward the end of the century²⁶.

3. Guns and Butter: Wars and the Bank

3.1. Sino-Japanese War, Russo-Japanese War and the Gold Standard (1890s-1900s)

²⁴ As of the end of 1881, currency in circulation totaled 196 million yen, out of which 119 million-yen was government notes, 34 million-yen was national bank notes, 24 million-yen was bullion coins (gold/silver), and 19 million-yen was subsidiary coins (silver/copper). The Bank of Japan (1986), pp.414-5.

²⁵ Fukuda (1995), pp.63-65, p.71.

²⁶ Shizume (2017).

Japan completed its entry to the modern world by the turn of the century. It had overcome the risk of being colonized and gained recognition as an emerging economy. Japanese policymakers regarded Japan as the only Asian country with the potential become an empire in the prevailing climate of imperialism of that time.

Under the silver standard, the Japanese economy grew at an annual rate of 3 percent over the period of 1886-1897 thanks to the depreciation of the yen against gold standard currencies (Table 2). A revised treaty between Japan and Great Britain in 1894 raised tariff rates and abolished Britain’s consular jurisdiction and unilateral most favored nation status. The revision of unequal treaties with other western countries followed, culminating in full tariff autonomy for Japan in 1911. By this point, Japan was recognized as an emerging empire and a full member of the international community of western powers.

Yet, new challenges arose for Japan as an emerging empire. As Japan’s external status improved, it faced rising costs to maintain its status and a growing trade-off between accumulating national wealth and the building of a strong army and navy. Upon joining the gold standard in 1897, Japan partly solved the tradeoff by stimulating international trade and gaining easy access to the international financial market.²⁷ Japan was partly rewarded by its success in raising huge funds in the international market during the Russo-Japanese War.²⁸ At the same time, however, Japan had to compensate for the war with slower growth through contractionary monetary and fiscal policies in order to maintain the gold convertibility. The Japanese economy expanded more slowly than in the previous years on the silver standard, growing at an annual rate of only 2 percent over the period of 1898-1913 (Table 3). The burden of overseas war debt imposed a new constraint on the conduct of monetary and fiscal policy after the war. Japan’s current account remained in the red and difficulties in financing the deficit persisted (Figure 1).

Table 3. Annual Percent Changes in Output and Prices (1886-1913)

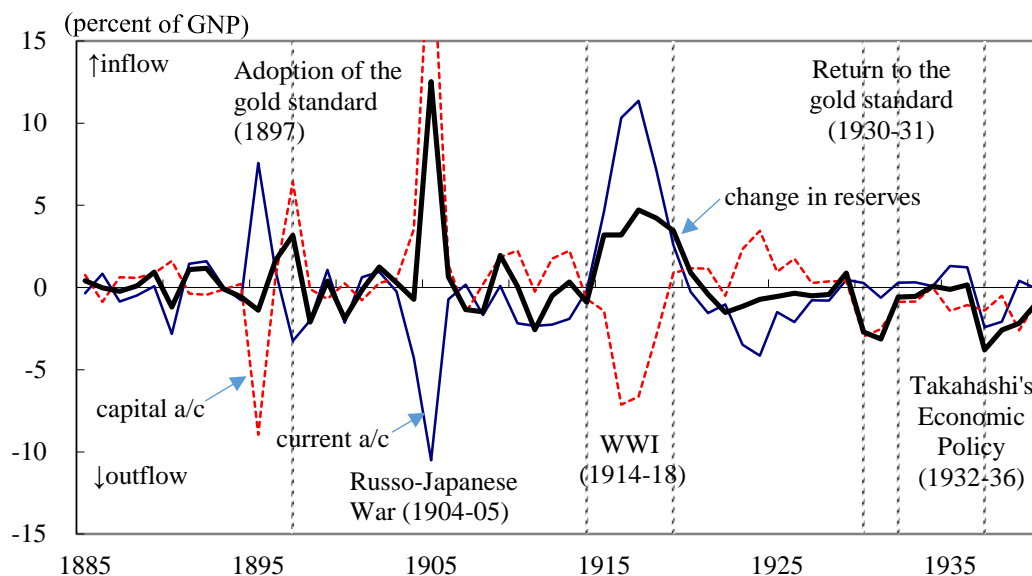
	Output (GNP)	Prices (GNP Deflator)
1886-1897	3.3	4.2
1898-1913	2.2	3.8

Source: Ohkawa et al. (1979), pp.251-260.

²⁷ Mitchener et al. (2010).

²⁸ Smethurst (2007), pp.141-187.

Figure 1. Balance of Payment



Sources: Yamazawa and Yamamoto (1979), pp.220-227; Ohkawa et al. (1979), pp.251-253.

3.2. World War I Boom and the Financial Crises (1910s-1920s)

World War I (WWI) was “divine providence” for Japan²⁹. Japan, distant from the battlefields of Europe and only fighting in the German colonies in Asia and in the Russian Far East, grew swiftly, accumulated current account surpluses, and joined the United States as a creditor country. The balance of payments no longer restricted monetary policy.

This gave rise, however, to a new trade-off between growth and stability. Following the boom during and just after WWI, Japan suffered from economic stagnation, price deflation, and bad loan problems through the 1920s. An economic backlash and the government’s attempt to maintain high economic growth even after the war created mounting bad loans among domestic commercial banks. Then, in 1923, the Great Kanto Earthquake hit the Tokyo metropolitan area and the BOJ introduced a special treatment facility for the devastated area. The BOJ’s intention *ex ante* was to rescue solvent, but illiquid banks. The facility was abused *ex post*, however, by banks already in financial distress, evincing a clear moral hazard problem.

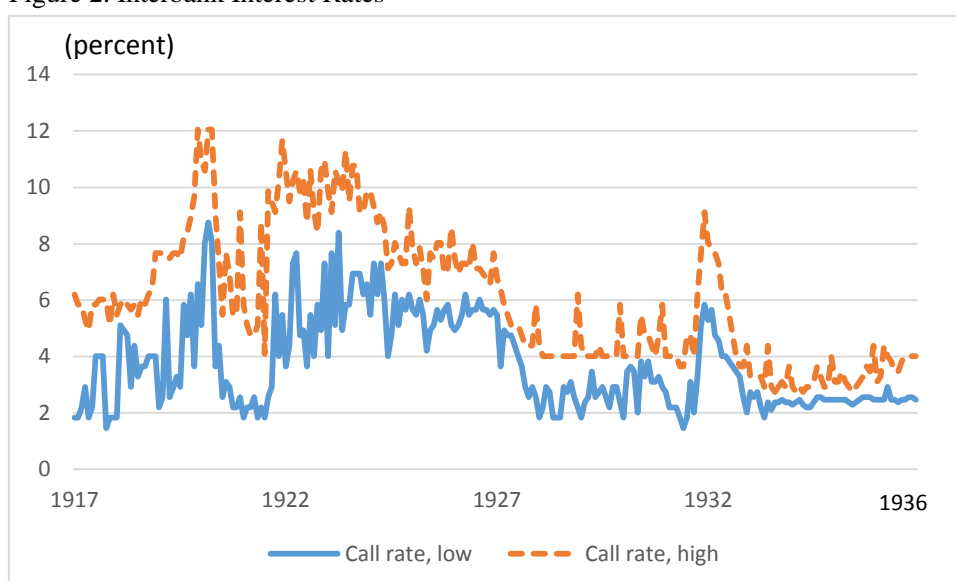
Financial panic spread nationwide in the spring of 1927 (Showa Financial Crisis). During the crisis, the BOJ functioned as an LoLR, swiftly extending its credit to combat bank runs. The crisis accelerated the long-awaited resolution of the bad loan problems and reforms of the financial system under the leadership of the government’s executive branch. In 1928, the authorities introduced a new scheme for a prudential policy encouraging mergers and acquisitions, bringing in new regulations,

²⁹ Metzler (2006), pp.91-111.

and instituting a system of dual inspection by the MOF and the BOJ³⁰.

With the steadying influence of banking reforms and public funding, financial stability was finally restored. Call rates, which had remained high between the financial panic of 1922 and Showa Financial Crisis of 1927, reflecting high-risk premia, fell substantially in the spring of 1927. This drop in rates stemmed from strong confidence in financial reforms among market participants, the disposition of the financial crisis, and the provisioning of liquidity by the BOJ secured by the government for potential losses (Figure 2)³¹.

Figure 2. Interbank Interest Rates



Source: The Ministry of Finance, *Reference Book of Financial Matters*, annual editions.

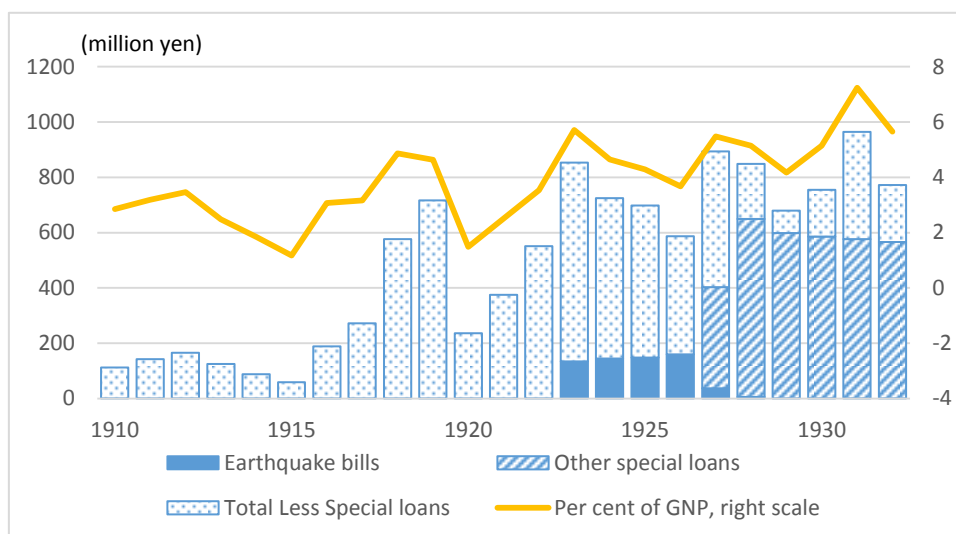
When financial stability was finally restored, entrenched lending by the BOJ imposed a new constraint on the operation of monetary policy. In practice, the BOJ lacked policy instruments to absorb funds from the financial markets. Most of the lending by the BOJ to the private sector after the Showa Financial Crisis of 1927 consisted of special loans. Though guaranteed by the government, the funds could not be easily removed from the financial markets. The BOJ had to bear a loss of flexibility in its monetary policy operation (Figure 3)³². In response, it turned to open market operations as a new device for absorbing funds from the financial markets using government bonds as instruments.

³⁰ Shizume (2016), p.2.

³¹ Shizume (2016), p.13.

³² Shizume (2016a), p.16.

Figure 3. BOJ Loans to the Private Sector



Source: The Ministry of Finance, *Reference Book for Financial Matters*, annual editions.

3.3. The Great Depression and Departure from the Gold Standard (1930-1936)

Japan sought to restore gold convertibility, which it had suspended in 1917, following the United States. In January of 1930, having resolved the financial crises of the earlier decade, Japan finally returned to the gold standard. A disastrous slump and deep deflation in Japan followed, just as the Great Depression was taking hold globally.³³

Japan stayed on the gold standard for less than two years. At the end of 1931, the veteran Finance Minister Korekiyo Takahashi led a major shift in the country's change in its macroeconomic policy. Takahashi departed from the gold standard in December 1931, initiating a drastic macroeconomic policy package including currency depreciation, fiscal stimulus, and monetary easing. Economic recovery in Japan preceded that in the United States and Europe. The Japanese economy grew at an annual rate of six percent during Takahashi's term in 1932-1936, with inflation contained to low levels.³⁴

The BOJ supported the price of government bonds by underwriting them, selling them to financial institutions, and keeping interest rates low. In return, the BOJ obtained the power to sell government securities without the permission of the MOF for each operation, and thereby to implement open market operations. By doing so the Bank planned to restore its ability to control the financial markets, something it had lost with mounting entrenched lending to private banks³⁵.

But then another issue arose as Japan proceeded along its recovery path. In September of 1931, the Japanese army started an undeclared war in Manchuria in northeastern China. Though

³³ Shizume (2012).

³⁴ Shibamoto and Shizume (2014).

³⁵ Ide (2003).

unexpected by the government and public, the war with China continued and expanded, overshadowing Japanese public finance. When convinced, in 1935, that the Japanese economy was finally on a path of steady growth, Finance Minister Takahashi negotiated to cut the military budget with plans to tighten fiscal stimulus. Then he was assassinated by a group of militarists in February 1936.

Shizume (2011) looks at the sustainability of public debt in Japan in the long run, revealing that debt sustainability was kept until 1931 and lost in and after 1932. He concludes that the loss of sustainability was mainly attributable to the loss of fiscal discipline when the international gold standard collapsed and Japan departed from the gold standard in fall-winter of 1932. Japan failed to establish a new system to govern fiscal policy, including military spending.³⁶ Shibamoto and Shizume (2014) also show that monetary policy during the interwar period was conducted in a manner accommodative to other economic and policy shocks.

3.4. The Asia-pacific War and Financial Repression (1937-1945)

As the war extended and expanded during the 1930s and early 1940s, war finance overwhelmed monetary policy. The BOJ devoted itself to the national objective, to fight the war, under the control of the government. Japan's war with China escalated to a full scale in 1937. In December 1936, the BOJ held less than 1 billion yen in government securities and owed less than 2 billion yen of banknotes in circulation. In December 1940, a year before the outbreak of the war with the United States, the BOJ held 4 billion yen in government securities and owed 5 billion yen of banknotes in circulation. In March 1945, four months before the end of the war, the BOJ held 8 billion yen in government securities, had loaned out 14 million yen mainly to war industries through other banks, and owed 21 billion yen of banknotes in circulation.³⁷

To suppress inflation pressures, the government and the BOJ relied on financial repression and the direct control of prices. In September 1937, the government imposed controls on international trade and long-term capital allocation. In January of 1938, it set the first Goods Mobilization Plan. In March and May of the same year, it passed and effectuated the National Total Mobilization Law, thus gaining the power to mobilize civilians for national goals. The Law became the basis of price controls and rationing on a wide variety of goods, services, employments, and wages. In April 1939, the government imposed controls on employment and wages. In October 1939, it promulgated the Prices Control Ordinance, a legislation virtually covering the prices of all goods and services. A year later, in October 1940, it promulgated the Ordinance to Regulate Banks'

³⁶ Pittaluga and Seghezza (2016) argue that Japan ran unsustainable external debts even before WWI, when Japan was on gold. Japan was allowed to do so, they claim, because Britain granted Japan easy access to the international financial markets in return for Japan's protection of British economic and political interests in the Far East.

³⁷ The Bank of Japan (1986), pp.290-293.

Allocation of Funds³⁸.

As Japan's relationship with foreign countries deteriorated, the United States imposed and tightened economic sanctions against Japan. In July 1940, the United States adopted a license system for the export of scrap iron and oil. In July 1941, in response to Japan's occupation of southern French Indochina, the United States froze all Japanese assets in its territories and placed a total ban on oil shipments to Japan. The Netherlands East Indies followed suit, imposing a ban on its own oil exports to Japan. Japan depended on the United States for resources and finance, so the sanctions aggravated shortages of materials essential for the Japanese economy. After Japan went to war with the United States in December of 1941, the Japanese government formulated the Plan for the Greater East Asia Co-Prosperity Sphere. Ultimately, the plan amounted to nothing more than a pie in the sky³⁹.

The Bank of Japan Act of 1882 was replaced by the Bank of Japan Act of 1942. The new act defined the BOJ as a state entity and strengthened the government's control on the BOJ's operations. The Act of 1942 was said to have been modeled after the German Reichsbank Law enacted under the Nazi regime⁴⁰. The convertibility clause, which had not been virtually effective since December 1931, was officially abolished at the same time. The Act of 1942 stipulated that the BOJ was to be responsible for the control of money, adjustment of finance, and reinforcement of the credit system in accordance with national policy, thereby fully utilizing the national economic power (Article 1). The BOJ was to devote itself entirely to achieving the national goal (Article 2). The Governor and Vice Governor were to be appointed by the government (Article 16). The Minister in charge (Finance Minister) had the authority to supervise the BOJ (Article 42). The Minister in charge was authorized to order the BOJ to take necessary actions, including changes of bylaws, if the minister recognized it to be necessary (Article 43).⁴¹ The Minister in charge was authorized to order financial institutions to cooperate with the BOJ if the minister recognized it to be necessary for achieving the BOJ's goals (Article 28). The BOJ was to issue banknotes for the benefit of all public and private transactions without any limit (Article 29). The BOJ had to obtain the permission of the Minister in charge for all decisions on its discount and lending rates (Article 21). The BOJ could lend to the government without taking collateral, and apply for or underwrite government securities (Article 22). The Bank of Japan Act of 1942 was marginally revised on several occasions in ensuing decades, but it virtually remained in effect up to 1998.

The BOJ played a pivotal role under the wartime regime. It allocated funds by rationing credit and supervised other financial institutions under the government. The war economy, however, was poorly controlled. Black markets flourished in hidden personal settings and plans for allocating

³⁸ Nakamura (1999), pp.55-77.

³⁹ Nakamura (1994), p.116; Nakamura (1999), pp.77-80.

⁴⁰ The Bank of Japan (1984), p.478.

⁴¹ The Bank of Japan (1986), p.210-212.

materials for the total war and daily necessities failed⁴².

3.5. The Post-War Inflation and Reconstruction of the Economy (1945-1950s)

Japan surrendered to the allied powers and the occupation began in September 1945. The occupation lasted until the San Francisco Peace Treaty took effect in April 1952. The Japanese government was allowed to exist and formulate policies subject to the permissions of the General Headquarters of the Allied Forces (GHQ).

The Japanese economy was in disarray. A major restructuring in the deployment of human resources was badly needed. Some 2.12 million soldiers died in battle and another 300 thousand persons died in air raids. About 7.2 million troops were to be demobilized, about 4 million workers in armaments factories would lose their jobs, and 1.5 million Japanese overseas would be repatriated. In the coal industry, the main energy source for Japan at the time, the repatriation of impressed workers from China and Korea resulted in a major energy shortage and bottleneck for economic recovery. As for physical assets, about one-fourth of the total was lost⁴³.

Uncontrollable inflation broke out at around the end of the war. Though we lack reliable statistics on wartime inflation, anecdotal evidence suggests that prices soared in the black markets. Two government measures accelerated the inflation from just after Japan's surrender in August 1945 through to the end of the year: the payment of war expenses to compensate repatriated soldiers and civilians who had worked for war industries or lost their houses in air raids, and the lifting of price controls on fresh foods to promote their supply⁴⁴. At the same time, black markets prevailed in the streets of the major cities once the war ended. The BOJ, which started collecting data on black market prices by as early as October 1945, estimated that retail prices in the black markets were 29 times higher than the official prices at the time and 92 times higher than prices from 1934 to 1936, a decade earlier (Figure 4).

The government took a set of Emergency Financial Measures to deal with the rampant inflation in February-March 1946. All cash had to be deposited in financial institutions, new banknotes were issued, limits were set on withdrawals, and strict government control over official prices was resumed. Inflation in black markets subsided in response, at least temporarily⁴⁵.

Shigeru Yoshida took power in May 1946 and stayed in power until 1954, with a brief break in 1947-1948. Japan moved toward an economic recovery and a return to the international community under his leadership. His approach, known as the "Yoshida Doctrine" (though he never used those words himself), was to concentrate on the recovery and development of the economy

⁴² According to a few witnesses, people were unable to survive without black markets. Nakamura (1994), pp.117-122.

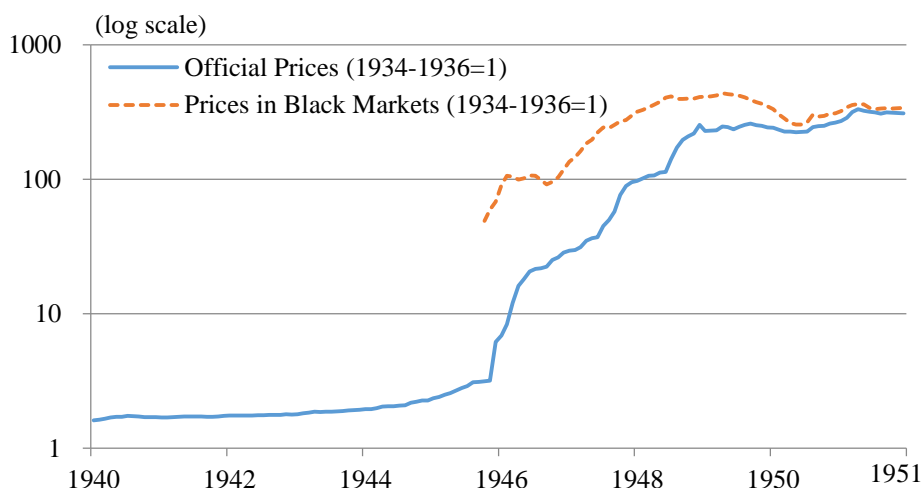
⁴³ Nakamura (1994), pp.123-124, 148.

⁴⁴ The Bank of Japan (1985), pp.17-18; Nakamura (1994), p.131.

⁴⁵ The Bank of Japan (1985), pp.38-45; Nakamura (1994), pp.149-150

while minimizing the burden of military spending by relying on American forces for national security. In a sense, he redefined the national goal as wealth without military power, freeing the BOJ from worries over war financing even though it was still bound to devote itself to the national goal under the Bank of Japan Act of 1942, which remained in effect⁴⁶.

Figure 4. Retail Prices



Sources: Toyo Keizai (1954), *Price Statistics of Pre/Post-War Period*; The Bank of Japan.

In 1947, the Yoshida Cabinet initiated the Priority Production System to boost the economy. The main idea was to concentrate physical and financial resources to key industries such as coal and steel, resolving a bottleneck in production and igniting the whole economy. The Reconstruction Finance Bank (RFB), a government-formed bank established in January 1947 to finance key industries, floated bonds to be underwritten by the BOJ. In the same year, BOJ underwriting of public debt was banned under the newly promulgated Public Finance Act (Article 5). Technically speaking, bonds issued by the RFB were not government bonds. In effect, however, the provision of central bank credit through the RFB reignited inflation (Figure 4)⁴⁷.

Hisato Ichimada, the BOJ Governor for the entire Yoshida Administration (1946-1954), later recalled the difficulty of pursuing the conflicting policy goals of controlling inflation and bringing about a recovery in production at the same time⁴⁸.

When Japan was about to reintegrate into the international community, a debate on the adjustment policy arose between hard-liners and soft-liners within the Japanese government and within the GHQ: the hard-liners insisted on containing inflation first, while the soft-liners argued for a more gradual path of balanced inflation and growth. The debate ended with the victory of the

⁴⁶ Nakamura (1994), p.175.

⁴⁷ The Bank of Japan (1985), pp.102-104, p.108; Nakamura (1994), pp.151-153.

⁴⁸ The Bank of Japan (1985), p.60.

hard-liners upon the arrival of Joseph Dodge, chairman of the Bank of Detroit, as an adviser to the Supreme Commander of the GHQ in December 1948. Under the hardline stabilization policy, the “Dodge Line,” Japan 1) imposed strict controls over the national budget and taxation to eliminate the fiscal deficit, 2) limited credit extensions to curb inflation, and 3) tightened foreign trade and exchange control. Dodge, an essential believer in free-market economy, recognized these policies as preconditions for the full re-entry of the Japanese economy into the international market under the Bretton Woods System. All of the hidden subsidies to industries and foreign trade were eliminated, along with any excess regulations not deemed to be essential as safeguards. The RFB stopped new lending in 1949 and dissolved in 1952. In April 1949, the exchange rate was set at 360 yen/dollar. The side effect was a severe economic contraction in 1949. But then another “divine providence,” the Korean War (1950-1953), helped Japan recover.⁴⁹

Under an amendment of the Bank of Japan Act spearheaded by the GHQ in June 1949, the BOJ introduced a policy board modeled after the Federal Reserve System. The GHQ wished to enhance the independence of the BOJ's policymaking⁵⁰. The new act invested the policy board with the authority to decide the BOJ's discount and lending rates without approval from the Finance Minister (Articles 13 and 21). The Finance Minister, meanwhile, retained the authority to supervise the BOJ (Article 42) and to order the BOJ to take actions recognized by the minister to be necessary, including changes of bylaws (Article 43). The provision effectively limited the legal independence of the BOJ. After the amendment, the BOJ was required to negotiate with the MOF before making any adjustment to the official discount. The board was often called "the sleeping board". These developments illustrate the relative lack of change in the policymaking process until the Act was amended in 1998⁵¹.

Japan concluded the San Francisco Peace Treaty in 1951 and joined the Bretton Woods System (International Monetary Fund: IMF) when the treaty came into effect the next year.

4. Japanese Miracle: Economic Growth and the Bank

4.1. Financing High Growth (1960s)

The Japanese economy grew at an unprecedented annual rate of 10 percent during the 1960s (Figure 5). In 1960, Prime Minister Hayato Ikeda, a former subordinate of Shigeru Yoshida, announced the National Income-Doubling Plan, a strategy to double Japan's real gross national product (GNP) within ten years. The plan was outpaced by the reality⁵². The keys for high growth were improvements in productivity through investments to expand capacities and introduce new technologies, and growth in the demand for consumer durables supported by sustained growth of

⁴⁹ The Bank of Japan (1985), pp.114-115, 199-245; Nakamura (1994), pp.155-170.

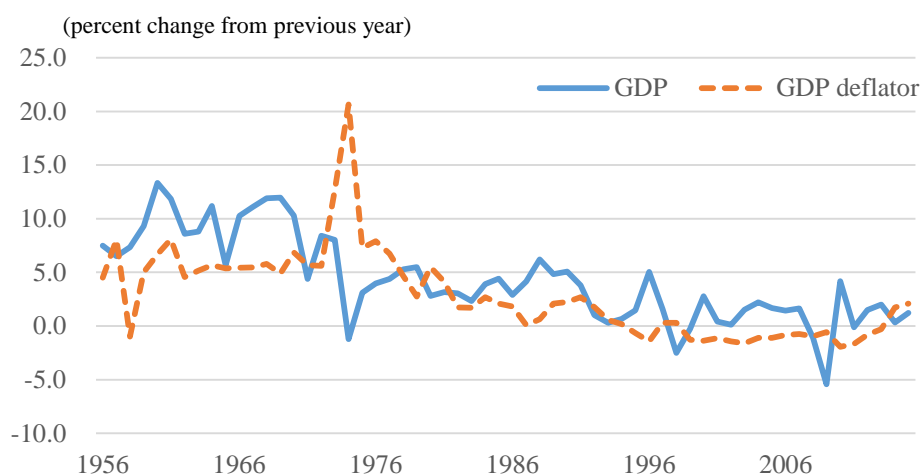
⁵⁰ The Bank of Japan (1985), pp.267-321.

⁵¹ The Bank of Japan (1985), pp.314-318.

⁵² Nakamura (1994), pp.211-212.

income and the emergence of the mass consumption society⁵³.

Figure 5. Output and Prices



Source: Cabinet Office.

The National Income-Doubling Plan assigned three roles to the public sector: to incubate facility for growth, remove impediments to growth, and conduct appropriate fiscal and monetary policy, in order to stabilize the value of the currency, provide finance for growth, and minimize the size of the business cycles. In practice, the BOJ kept interest rates as low as possible, and tightened monetary policy when the external balance deteriorated and foreign reserves fell to a certain level. As international capital movements were strictly regulated, the current account was the primary determinant of the overall balance of payments. When the boom continued and domestic demand reached a certain level, the balance of payments turned to the red, signaling that the time for monetary tightening had come (Figure 6).

The Japanese financial sector was heavily regulated in this period. Interest rates were virtually determined by the ordinance in accordance with changes in the official discount rate of the BOJ. The BOJ used the reserve deposit requirement ratio and “window guidance” to supplement the interest rate policy. Because interest rates were below the equilibrium, an excess demand for funds always existed. The big banks depended on borrowing from the BOJ, and the window guidance was a form of moral suasion by the BOJ to guide the credit of private banks.⁵⁴

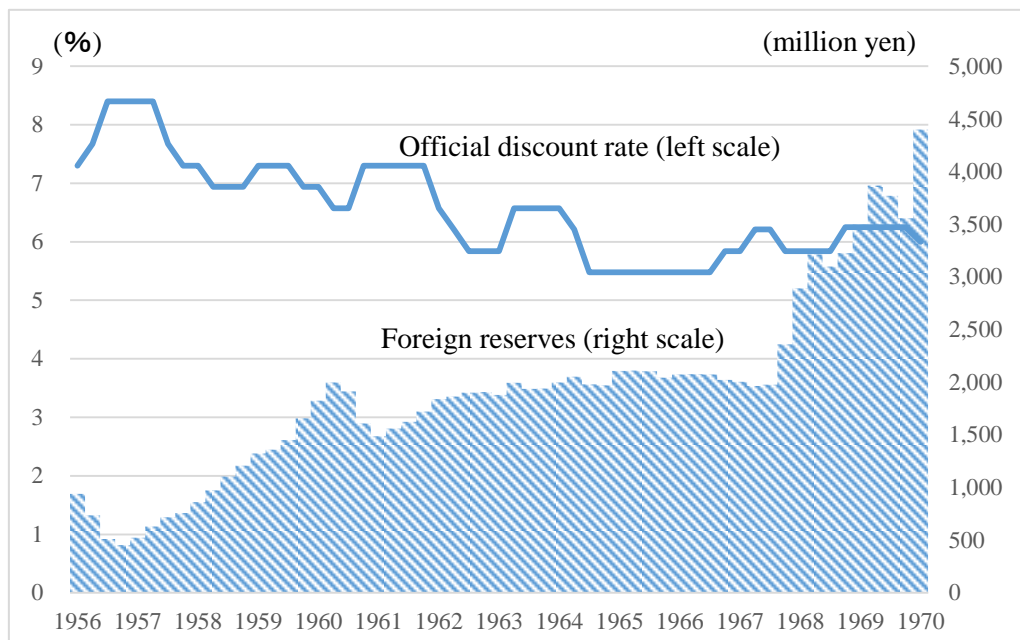
Japan became an Article 8 member of the IMF in 1964. By doing so, it committed itself to abandoning all restriction of trade accounts while still enjoying the privilege of restricting capital

⁵³ Lincoln (1998), pp.255-260.

⁵⁴ Itoh et al. (2015), pp.188-189, pp.193-196.

accounts⁵⁵.

Figure 6. Foreign Reserves and Official Discount Rate of the BOJ



Source: Bank of Japan, *Economic Statistics Annual*, annual editions.

4.2. From the Developing World to the Developed World (1970s-1980s)

4.2.1. Two Oil Shocks

The Japanese economy had caught up with the western economies in productivity and per capita income by the early 1970s, but it also faced new challenges. In August 1971, the Nixon Administration of the United States unilaterally declared suspension of gold convertibility of the dollar to deal with its current account deficit. The Smithsonian Agreement of December 1971 pushed up the exchange value of the yen from 360 yen/dollar to 308 yen/dollar. The agreement collapsed in the spring of 1973 and the major countries moved into a flexible exchange rate system.

Fearing negative impacts from the appreciation of the yen, the Japanese government and the BOJ responded by instituting easy fiscal and monetary policies. Meanwhile, a self-confident Kakuei Tanaka became prime minister in 1972, bringing with him a “Plan to build a New Japan.” Tanaka assumed that high growth would continue over the long run and wanted to redistribute the fruits of high growth out from the Tokyo-Osaka area to rural parts of the country. Under his leadership, the Economic Planning Agency (EPA) drew up a new five-year plan forecasting 9 percent real GNP growth for 1973-1977⁵⁶.

⁵⁵ Nakamura (1994), p.214.

⁵⁶ The Bank of Japan (1985), pp.399-404; Lincoln (1998), pp.260-263.

When the first oil shock broke out in the fall of 1973, the easy macroeconomic environment sparked inflationary expectations and speculations by businesses and consumers. Labor Unions demanded wage increases of more than 20 percent in 1973 and more than 30 percent only a year later, in 1974. The inflation of consumer prices rose to 12 percent in 1973 and 25 percent in 1974. The BOJ raised the official discount rate from 4.25 percent in the end of 1972 to 9 percent a year later. The Japanese economy recorded negative growth for the first time since WWII in 1974 and average annual growth of 4 percent from 1973 to 1977 (Figure 5)⁵⁷.

Japanese policymakers, businesses, consumers, and labor unions learned lessons from the first oil shock. At the outbreak of the second oil shock in 1979, they responded much more prudently and promptly than they had in the first oil shock. The BOJ quickly tightened monetary policy, businesses and consumers refrained from speculative investments, and labor unions negotiated with a more cooperative stance than before. The Japanese economy experienced lower inflation than it had during the first oil shock and suffered no major economic contraction⁵⁸.

In the late 1970s and early 1980s, the Japanese economy grew steadily at 3-5 percent annually. Consumers favored Japanese products, both in Japan and other parts of the world. “Made in Japan” meant high-quality goods, a dramatic reversal from before. Japan continued to record a current account surplus. By as early as the 1970s, Japan was recognized as one of the great powers and its economy had grown to become the second largest in the world.

4.2.2. Financial Liberalization and Attempts toward International Policy Coordination (1980s)

The Japanese economy experienced a massive internationalization throughout the 1980s and 1990s. The main driving force was the country’s relationship with the United States. Huge trade imbalances spurred the Reagan Administration to demand that Japan open its markets to American businesses. Whether ill-motivated or not, the Report of the Yen-Dollar Committee in 1984 bolstered a transformation of the Japanese financial system, deregulation and liberalization of financial activities, and profound changes in the operation of monetary policy. During the negotiations for the conclusion of the report, Japanese policymakers eliminated remaining regulation on international capital movement and committed to a bold and steady liberalization of interest rates on deposits, as well as bank lending. The BOJ accepted these decisions and assertively switched from monetary policy operations based on regulations and window guidance to those based on market operations. The move started in 1988 and was completed by the time the BOJ implemented a full set of reforms under the new Bank of Japan Act of 1998⁵⁹.

During the second term of the Reagan Administration (1985-1989), the major western economies and Japan made major attempts to form internationally coordinated macroeconomic

⁵⁷ The Bank of Japan (1985), pp.420-441.

⁵⁸ Itoh et al. (2015), p.102-106.

⁵⁹ Itoh et al. (2015), pp.191-192.

policies, including exchange rate, monetary, and fiscal policies. The Plaza Accord of September 1985 aimed to bring down the dollar through concerted interventions in foreign exchange markets in order to shift demand from Japanese to American products. The Louvre Accord of February 1987 aimed to adjust the domestic demand of major countries by coordinating monetary policies, fiscal policies, and policies for communication on exchange rates. The attempts were led by the U.S. Secretary of the Treasury James Baker and the Japanese Finance Minister Kiichi Miyazawa, and the central banks of their respective countries were deeply involved in the process. By the end of the decade, the central banks reached a broad consensus on the technical and political obstacles to effective coordination, agreeing on the benefits to be gained by “putting one’s garden in order”⁶⁰.

At the high tide of these transformations, the asset price bubble emerged, expanded, and later busted. The emergence and expansion of the bubble took place when price stability seemed to be maintained. While the background of the bubble had multiple aspects, intensified bullish expectations for asset prices and the prospects of the economy played an important role. The BOJ learned a lesson: from a long-run perspective, a central bank had to conduct monetary policy focused on the stability of the financial system as well as the stability of prices⁶¹.

4.3. New Challenges (1990s-present)

A fully revised Bank of Japan Act effectuated in 1998 stipulates the policy formation autonomy of the BOJ and requires transparency of the Bank. The purposes of the BOJ are to issue banknotes, carry out currency and monetary control, and ensure smooth settlement of funds among banks and other institutions, thereby contributing to the stability of the financial system (Article 1). The currency and monetary controls of the BOJ shall aim to achieve price stability, and thereby contribute to the sound development of the national economy (Article 2). The BOJ’s autonomy regarding currency and monetary control shall be respected, while the BOJ shall endeavor to clarify to the citizens the content of its decisions and decision-making process regarding currency and monetary control (Article 3).

After the burst of the asset price bubble, the bad loan problem shadowed the Japanese financial system and conduct of monetary policy. The prudential policy was the main responsibility of the Financial Services Agency, with some involvement of the BOJ. Meanwhile, Financial instability due to the bursting of the bubble and mounting non-performing assets imposed severe constraints on the monetary policy⁶².

The financial instability of the 1990s peaked when a number of major financial institutions failed from 1997 to 1998 (Heisei Financial Crisis). Several large securities houses and other financial institutions, including one of Japan’s city banks with a nationwide branch network,

⁶⁰ Volcker and Gyoten (1992), pp.228-286; Itoh et al. (2015), pp.124-159.

⁶¹ Okina et al. (2001), pp.444-445.

⁶² Nakaso (2001).

collapsed in the span of a few weeks in November 1997. Meanwhile, the Asian financial crisis erupted in Thailand in July 1997 and spread to Korea and other countries within months, exacerbating the domestic crisis. Rumors and speculations that certain other banks were on the brink of collapse spread, compelling depositors to form long queues at those banks to withdraw their money. Then, the Long Term Credit Bank of Japan, an institution with total assets of 26 trillion yen (240 billion US dollars), ran into fundraising troubles in the summer of 1998 and was nationalized in October 1998. The BOJ played a role in containing the crisis as the LoLR on an unprecedented scale. Eventually, with help from a massive capital injection and other legislative interventions, the crisis subsided.⁶³

Among central banks in the world since WWII, the BOJ was the first to hit the zero lower bound and introduce “unconventional” monetary policy measures. To deal with economic stagnation under the financial instability, the BOJ virtually hit the zero lower bound in 1995 and initiated the zero-interest rate policy (ZIRP) in 1999-2000⁶⁴. It went on to implement the quantitative easing policy (QE) in 2001-2006 and the comprehensive monetary easing policy in 2010-2013. It then introduced the quantitative and qualitative monetary easing policy (QQE) in 2013 and the new framework for strengthening monetary easing by quantitative and qualitative monetary easing with yield curve control in 2016 (Figure 7)⁶⁵. Despite these innovations in monetary policy, growth of the money stock has remained stable and stagnant since the 1990s, suggesting that structural factors such as the aging of the population and low investment demand of new IT industries with large network externalities may lay behind the stagnation (Figure 8)⁶⁶.

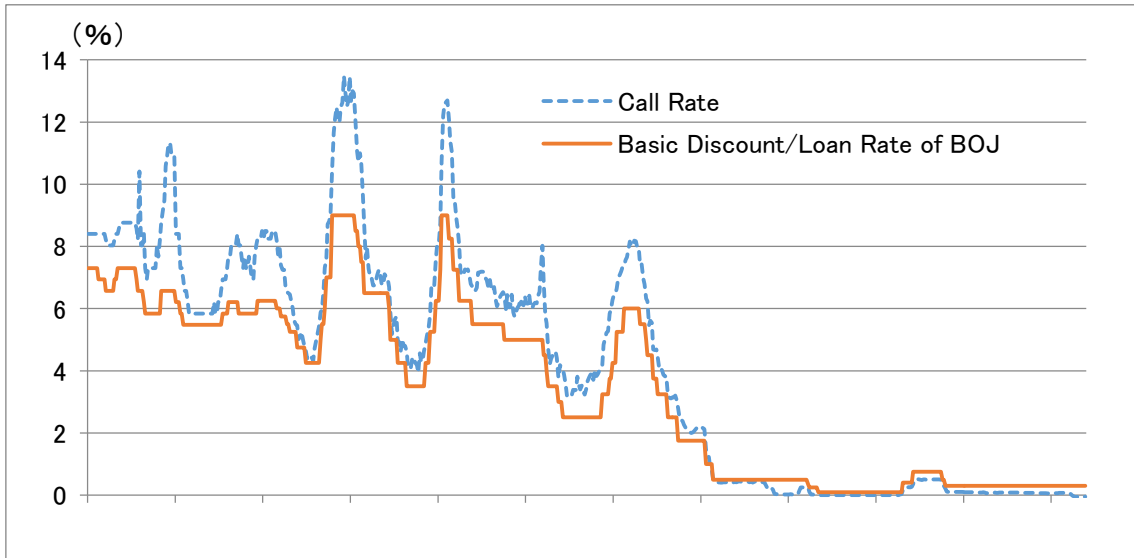
⁶³ Nakaso (2001), pp.8-16.

⁶⁴ Ueda (2005a), p.22; Ueda (2005b), p.3.

⁶⁵ HP of the Bank of Japan: https://www.boj.or.jp/en/mopo/mpmdeci/mpr_2016/index.htm/
Accessed on 26 December 2016.

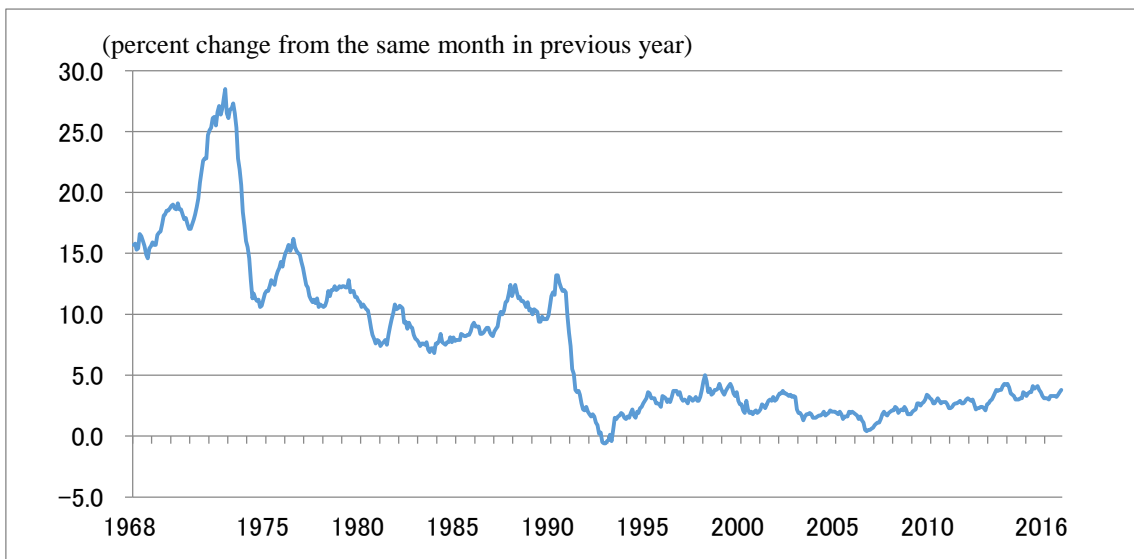
⁶⁶ Shirakawa (2012). Okina and Shiratsuka (2004) argue that the downward shift in long-term economic growth in Japan was caused by multi-dimensional structural impediments to the smooth reallocation of economic resources. Baldwin and Teulings (2014) summarize discussions on secular stagnation in the global context.

Figure 7. Interbank Rate and Lending Rate of the BOJ



Source: The Bank of Japan.

Figure 8. Money Stock (M2)



Source: The Bank of Japan.

5. Conclusion

The BOJ's mandate and role within society has changed over time. When Japan joined the modern world in the late 19th century, the Bank was created as an entity to integrate the national financial market and provide liquidity for economic growth. When Japan pursued its goal as an empire in the first half of the 20th century, the Bank played a pivotal role in financing wars and in stabilizing the national financial markets. During and after Japan's losing war with its main trading partners in the

1930s and 1940s, the Bank was overwhelmed by ballooning government debt and rampant post-war inflation. When Japan re-focused its national goal on high economic growth during the 1960s and early 1970s, the Bank was revived as an engine to fuel liquidity into the national economy. Once the Japanese economy reached an advanced stage of development from the 1970s onward, the Bank's main task changed from providing liquidity for economic growth to stabilizing the domestic economy. In pursuing this task, the Bank has often faced trade-offs between guns and butter, stability and growth, and the threat of economic backlash and the moral hazard problem. The Bank has been and still is learning from new challenges.

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