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Bank of Japan's Independence Eyed as Yen Slide Looks to Continue

By: MARTIN BACCARDAX - November 21, 2012

As central banks around the world continue to occupy centre stage in theglobal economic drama a potentially game-changing shift is taking place in Japan that could have major implications for monetary policy.

Long-suffering Japanese voters will head to the polls again next month to elect their seventh Prime Minister in only six years. Front-runner Shinzo Abe of the conservative establishment Liberal Democratic Party has put Japan's anaemic economy at the forefront of his campaign, promising legal changes that would compel the independent central Bank of Japan to adjust its policies in co-ordination with the government's fiscal aims.

The suggestions have elicited a rare public rebuke from its normally recalcitrant Governor, Masaaki Shirakawa, and put global investors in a speculative mood as they increase bets on the longer-term weakness of the Yen.

"Our focus is on whether the new government will put pressure on the BoJ regarding the exchange rate," wrote Societe Generale analyst Klyoko Katahira. "However, the chances for a shift in FX policy - potentially a radical shift - are higher in the coming fiscal year, once the top three policy board members - the governor and the two deputy governors - will have been replaced."

Traders are already anticipating the impact of a government-directed BoJ, which Abe has said he would like to see applying a more aggressive monetary policy to Japan's moribund economy.

The yen fell to a seven and half month low of 82.05 against the US dollar and the lowest since early May against the Euro after Abe's LDP spokespeople hinted at changes to the Bank of Japan Act - the legal framework under which the BoJ has operated since 1997 - that would lead to lower (and possible negative) interest rates, an increased inflation target and the direct underwriting of government bonds.

The latter, said Shirakawa, is at the "top of the list of things you shouldn't do. No advanced country has adopted such a policy. Even the perception that the BoJ is directly underwriting government debt could lead to higher interest rates and hurt public finances."

These weren't the only public thoughts of a likely-departing central banker, who took aim at Abe's idea of a 3 percent inflation target ("unrealistic") and legal changes that would threaten the Bank's independence ("created upon bitter lessons learned").

Just a little respect

"I want respect for the BOJ's independence as it's doing its utmost to conduct appropriate monetary policy," he declared.

He may have a point, but it's hardly likely to matter if, as the polls suggest, Abe is swept back into power on 16 December. The former lawyer - who famously has little interest in finance or economics - appears determined to take a major roll of the dice in an effort to extract Japan from its second-consecutive "lost decade".

Grim economic data certainly underlines his urgency: Japan's October exports sank a full 6.5 percent from the same time last year and its nine-month total is some 2.3 percent off of the 2011 tally and the worst in three years. Shipments to China, its most important trading partner, are off 11.6 percent as the economic toll of its political dispute over the East China Sea islands continues to mount.

Its trade deficit sits at an all-time high of 5.3 trillion yen and its GDP is on the ropes having contracted an annualised 3.5 percent in the third quarter as it heads towards yet another recession.

But that's not to say the BoJ hasn't thrown everything at the problem, either: It's had eight separate rounds of quantitative easing that amounts to more than 60 trillion yen and set up a collateral lending programme worth around 80 trillion yen. It's near-zero interest rates help support directed loan schemes to industries such as clean technology and nursing care and it has eased collateral rules for loans linked to earthquake rehabilitation.

Still, it's barely caused ripple in Japan's structurally imperilled economy and Abe is itching to do more.

Shirakawa's five year term as Governor wraps up in April, just one month after the departure of his two loyal deputies: Hirohide Yamaguchi and Kiyohiko Nishimura. The three vacant seats offer Abe a golden opportunity to at the very least install pliant, dovish allies onto the nine member board even if he's not able to drum-up support for wholesale change to the BoJ Act.

Bank stacking

This kind of "appointment influence" has a rich political history - Supreme Court 'stacking', for instance, is well documented. But a similar approach in monetary policy terms is rare.

That said, the issue of central bank independence has become increasing more important since the 2008 financial crisis and the co-ordinated rate cuts agreed in the wake of the collapse or Lehman Brothers.

Earlier this summer, critics suggested the European Central Bank's programme of Outright Monetary Transactions - where it plans to buy bonds issued by struggling Eurozone members - breached that very threshold by demanding that nation's first seek formal financial assistance from the EU and the IMF. In effect, many argued, the ECB was making judgements about a country's fiscal policies.

"I share those views which argue this is not monetary policy anymore," former ECB Chief Economist Jurgen Stark told Bloomberg Television this week. "(The OMT) undermines monetary policy, it undermines the independence of a central bank."

Others, however, dismiss the notion of true central bank impartiality as a practical impossibility.

"The most direct way that (central banks) are prevented from acting independently is when governments run large deficits," argues Gerry O'Driscoll, a senior fellow at the Cato Institute. "It's impossible for them to not monetize some of that. Currently (the Federal Reserve) is buying more than 70 percent of US debt obligations and no central bank can be truly independent if they're doing that."

The same could be said of the Bank of England, which agreed to return some £50bn of coupon interest earned through its £375bn quantitative easing programme to the Treasury over the next two years to assist Chancellor George Osborne's politically incendiary debt reduction pledges.

It could be argued that the current policies of the Fed, the ECB and the BoE are easily reversible - at least theoretically - in transparent financial markets. Legislated mandate changes and "Bank stacking", on the other hand, represent a Rubicon that's far more difficult to retrace.