Chapter I Introduction

As the central bank of Japan, the Bank of Japan issues banknotes (Bank of Japan notes). The Bank works to maintain the stability of prices and the financial system to ensure the trustworthiness of money as a means to settle economic transactions. The Bank conducts various business operations, including conducting monetary policy and fulfilling the function of being the lender of last resort, in order to contribute to the steady development of the Japanese economy. This chapter gives an overview of the functions and operations of the Bank.

A. Functions of the Bank of Japan

1. The Bank in the daily lives of the people

The Bank currently issues Bank of Japan notes (hereafter, "banknotes") in four denominations — 10,000 yen, 5,000 yen, 2,000 yen, and 1,000 yen — and works to ensure their smooth circulation throughout the economy. The amount outstanding of banknotes in circulation totaled about 77 trillion yen as of the end of March 2010. Other services provided by the Bank that are familiar to people include ensuring the smooth receipt and payment of the government's funds (treasury funds), such as the payment of public pensions and collection of national taxes. Taking pension payments as an example, the Bank endeavors to ensure that the beneficiaries receive their pensions on the due date by employing the following procedures: upon request of the government, the Bank transfers funds from the government's account at the Bank to the designated financial institutions' accounts at the Bank, and instructs the financial institutions to make such payments. In this way, the Bank — in line with providing the foundations to support the economic activities of individuals and firms through its business operations as the central bank — contributes to the steady development of the Japanese economy by conducting monetary policy and ensuring the stability of the financial system.

The Bank was founded in 1882 as the central bank of Japan. The Bank's purposes and its organizational management are stipulated in the Bank of

Japan Act[1] (see Box 1, "Central Banks around the World").

The Bank's major purposes can be summarized as maintaining price stability and financial system stability.[2] The roles of the Bank in achieving those purposes can be described from several viewpoints. For example, the Bank's roles can be classified by type of business operations as follows: (1) the issuer of banknotes; (2) the bank of banks; and (3) the bank of the government (see Box 2, "The Three Functions of the Bank of Japan as a Central Bank"). When focusing on the aspect of the Bank as an entity to take policy actions, the Bank's roles of conducting monetary policy and being the lender of last resort can also be cited.

Having looked at these various functions and purposes of the Bank, the question arises as to how they are related to each other. In order to provide a starting point to come up with the answer, the following sections begin by explaining how the Bank plays various roles through its business operations as a member of financial markets.

2. The Bank's operations as "a bank"

Individuals and firms make deposits at financial institutions. They withdraw cash from their accounts when necessary, or use their deposits to settle various transactions by funds transfers between financial institutions' accounts. Using the funds deposited with them, financial institutions manage their assets through a range of activities, such as lending and/or investment in bonds.

The Bank does not accept deposits from individuals or firms, but accepts deposits from financial institutions that hold current accounts at the Bank (hereafter, "BOJ account deposits"). Financial institutions conduct funds transfers with other financial institutions via BOJ account deposits. The Bank

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[1] The Bank of Japan Act was enacted in 1942, during World War II, to replace the Act of 1882. After that, in view of the globalization of the economy and finance, as well as the expansion of the market economy, a fundamental revision to the central banking system was discussed. As a result, the Act of 1942 was revised fully in 1997, and a new Act was enforced in 1998 under the two principles of respecting the autonomy of the Bank and ensuring the transparency of its monetary policy and business operations. See Appendix 1 for the full text of the current Bank of Japan Act.

[2] The Bank of Japan Act stipulates the Bank's purposes as follows: (1) the Bank issues banknotes and carries out its monetary policy (expressed in the Act as "currency and monetary control") (Article 1, paragraph 1); (2) the Bank's conduct of monetary policy shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy (Article 2); and (3) the Bank ensures smooth and stable operations of payment and settlement systems, and financial system stability (expressed in the Act as "to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of stability of the financial system") (Article 1, paragraph 2).

also conducts funds transfers related to lending, sales, and purchases of bonds with counterparty financial institutions. In these respects, the nature of the Bank's banking operations is not very different from that of private financial institutions' operations. On the other hand, while private financial institutions do not do so, the Bank issues banknotes as the sole issuer of banknotes in Japan.[3] The issuance of banknotes to financial institutions is conducted by debiting the equivalent amount from their BOJ account deposits.[4]

3. Issuing central bank money

In addition to cash, which consists of banknotes and coins, demand deposits (see Chapter IV.B.2), including current deposits and savings deposits, which households and firms hold at financial institutions, play a major role as payment instruments. These instruments are generally referred to as money. Banknotes and BOJ account deposits are together referred to as central bank money (see Figure 1-1). Central bank money and coins are safe forms of money, with no chance of default,[5] and they are important in daily payment and settlement.

For example, when people go shopping and pay a small amount, they hand over cash at the cashier to complete the settlement. People obtain cash by making a withdrawal from their accounts at financial institutions, and in preparation for such requests, financial institutions withdraw cash from their BOJ account deposits.

Meanwhile, in the case of a payment to a counterparty in a distant location, or a payment of a large amount, funds transfer is often used to settle the transaction. In such case, the settlement is not completed at the time when the payer requests the funds transfer at a financial institution's counter. When the payer's account and the payee's account are held at different financial institutions, it is necessary to process the settlement between the two institutions by transferring funds between the BOJ account deposits these institutions hold. Transactions between financial institutions, without any customer request, are also often settled by the transfer of funds between BOJ account deposits.

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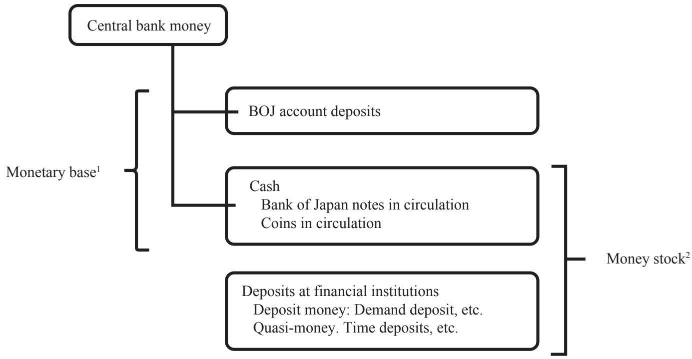
[3] Coins are delivered to the Bank by the government (issuance of coins), and then distributed to financial institutions by the Bank (see Chapter III.A.1).

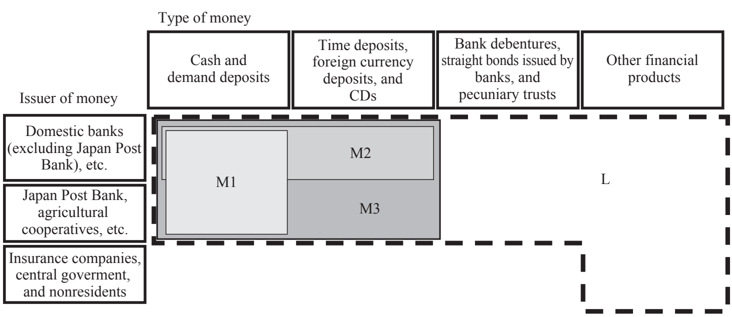
[4] At this time, in the liabilities on the Bank's balance sheet (see Box 3 for Chapter II, "The Bank of Japan's Accounts"), the amount of banknotes increases, while the same amount of current account balances at the Bank decreases.

[5] Central bank money has such characteristics as safety, liquidity, and the highest settlement finality (see Chapter IV). Although these are not characteristics exclusive to central bank money, each one of them is particularly prominent in central bank money.

Figure 1-1 Classification of "Money"



Notes: 1. Monetary base cosists of BOJ account deposits and cash, and is also referred to as "base money" or "high-powered money."
2. Money stock is the aggregate amount of money, including cash and deposit money, held by money holders such as nonfinancial corporations, individuals, and local govemments. It also indicates the total amount of money supplied from the financial sector to the entire economy. The Bank compiles and releases four indices, namely, M1, M2. M3, andL (broadly-defined liquidity).



4. The central bank as the guardian of money

The functions unique to a central bank can be boiled down to ensuring that people can use their money with confidence.[6] There are two conditions necessary

[6] The Bank of Japan Act stipulates that: "Bank of Japan notes shall be legal tender and hence shall be used for payment without limits" (Article 46, paragraph 2). In other words, its banknotes are a legally defined payment instrument that should not be refused by any creditor in satisfaction of any debt (see Chapter III). However, as it is not obligatory to use Bank of Japan notes for payment, it is important for Bank of Japan notes to possess the characteristics of convenience and safety so that people can use them widely as money.

to achieve public confidence in money.

First, the value of money must be stable. As for the stability of its value, there is stability in terms of the internal value (price stability) and the external value (stability of the foreign exchange rate). As described above, one of the Bank's purposes is to maintain price stability.[7] If price stability is impaired and people become concerned that the real-term value of money will considerably fluctuate over the short term, it may be difficult for firms and households to make appropriate decisions concerning their savings and investments, resulting in impairing the efficiency of economic activity.

Second, arrangements for payment and settlement (payment and settlement systems), including the circulation of money, and the financial system[8] must function smoothly and stably. If people are anxious about the financial soundness of financial institutions at which they hold their accounts, and suspect that the smooth conduct of payment and settlement may be disrupted, the function of payment and settlement through deposit money may deteriorate. In such a case, economic transactions may become stagnant. In an extreme case, people may begin to use foreign money, instead of their own country's money, to make payments, and may even resort to barter transactions.

Therefore, the Bank's purposes, such as maintaining price stability and financial system stability,[9] as stipulated in the Bank of Japan Act, are closely connected to public confidence in money. In this way, the Bank contributes to maintaining the foundation of stable and efficient economic activity.

The Bank conducts monetary policy in order to achieve price stability, thereby contributing to the sound development of the national economy. For this purpose, the Bank controls the money market interest rate by adjusting changes in the current account balances at the Bank through transactions with financial institutions, including the lending and sale/purchase of financial assets (transactions that the Bank conducts to achieve such a purpose are referred to

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[7] The Ministry of Finance has the legal authority to stabilize the foreign exchange rate (see Box 2 for Chapter VIII, "Institutional Design of Foreign Exchange Intervention: International Comparison"). The stability of the foreign exchange rate is not the main purpose of the Bank's monetary policy. However, as the Bank conducts monetary policy, it also takes into account the influence of the foreign exchange rate on economic activity and prices.

[8] See Section B.3 in this chapter for the definition of the financial system.

[9] Specifically, the Bank contributes to ensuring the stability of payment and settlement systems, and that of financial systems, by providing payment instruments, operating payment and settlement systems (see Chapter IV), and through functioning as the lender of last resort (see Chapter VI). For the stability of payment and settlement systems, and that of financial systems, the government also needs to play an important role, particularly in areas such as those of legislation and regulation.

as operations). The reason the Bank can play the role of the monetary policy authority derives from the fact that the Bank, as an entity providing central bank money, can adjust the changes in current account balances at the Bank in order to control the level of the short-term interest rate. Moreover, in the event that the stability of the payment and settlement systems or that of the financial system is jeopardized, the Bank, as the country's central bank, can provide funds to financial institutions as the lender of last resort. The reason that this lender of last resort function works effectively derives from the fact that the Bank can provide central bank money, which anyone can use with confidence, without limit, even in the event of a crisis. When anxiety about the financial system arises in the market, the function of highly credible central bank money becomes very important. In this way, the Bank maintains the function of money through conducting banking business with financial institutions based on the money issuing function, which the Bank possesses as a central bank.

Historically, central banks are likely to be exposed to the pressure to adopt an inflationary policy in the conduct of monetary policy. In fact, there have been many cases of a large amount of money being issued to cover fiscal expenditures, which thus led to serious inflation.[10] As the background, it is pointed out that central banks are likely to be exposed to the pressure to achieve immediate economic improvement, partly because it takes time to see the effects of monetary policy on economic activity and prices. Based on the points described above, it is recognized that there is a need to develop a framework in which monetary policy can be decided from a medium- to long-term viewpoint regardless of short-term benefits. Establishing an autonomous central bank is now a global standard (see Box 3, "Monetary Policy Independence").

B. Outline of the Bank of Japan's Business Operations

As described in Section A, in order to achieve the purposes of ensuring the stability of prices and the financial system, the Bank of Japan, through banking operations, fulfills the functions of issuing and managing money that people can use with confidence. The following outlines the daily business operations of the Bank in four categories: (1) provision of cash, and of payment and settlement services; (2) conduct of monetary policy; (3) ensuring of financial system stability; and (4) provision of government-related services.

[10] Based on these experiences, extending central banks' credit to governments is strictly restricted by law in many countries (see Chapter IX).

1. Provision of cash, and of payment and settlement services

As described in the previous section, the basis of business operations provided by the Bank, as the central bank in Japan, is to make the use of cash more convenient, and to ensure that individuals and firms can use it with confidence for daily transactions of trade and settlement. Therefore, the Bank ensures smooth circulation of banknotes nationwide, while working to manage the quality of banknotes and to prevent the use of counterfeit banknotes in order to maintain their cleanliness and safety. Business operations concerning banknotes are explained in Chapter III, "The Issuance, Circulation, and Maintenance of Bank of Japan Notes."

In addition to banknotes, BOJ account deposits held by financial institutions are important payment instruments. The Bank provides various payment and settlement services for financial institutions using their BOJ account deposits. As described later, market operations — the Bank's operational instruments for monetary policy (see Section B.2 in this chapter) — and the lender-of-last-resort provision of funds (see Section B.3 in this chapter) are examples of such transactions between the Bank and financial institutions, and are settled through BOJ account deposits.[11]

The Bank also provides settlement services related to Japanese government securities (JGSs) through the operation of the Japanese Government Bond (JGB) Book-Entry System. The Bank introduced online delivery-versus-payment (DVP) processing via a computer network (the Bank of Japan Financial Network System [BOJ-NET]) in order to facilitate smooth and efficient provision of payment and settlement services through BOJ account deposits, and such services related to JGSs. The Bank continues to improve these systems, and implements measures to reduce various risks involved in payment and settlement as much as possible. It conducts monitoring and assessment of payment and settlement systems operated by the private sector, and induces changes for improvement through its oversight activities.

In Chapter IV, "Payment and Settlement and the Roles of the Bank of Japan," the Bank's transactions with financial institutions through BOJ account deposits, which provide the foundation for various business operations of the Bank, are explained. Chapter IV also provides a comprehensive overview of the structure of Japan's payment and settlement systems and the Bank's role in such systems, and explains international cooperation for improving payment

[11] Under the reserve requirement system, financial institutions are subject to a requirement to maintain a certain fraction of deposits received from their customers as reserves. These reserves are, in principle, deposited in BOJ accounts (see chapters IV and V).

and settlement systems, which includes the Bank's participation in the oversight of global payment and settlement systems. Moreover, the Bank accepts deposits from other central banks and international organizations, and extends credit to them when necessary. These business operations are explained in Chapter VIII, "International Operations and Services."

2. Conduct of monetary policy

The Bank of Japan Act stipulates the principle that monetary policy shall be "aimed at achieving price stability, thereby contributing to the sound development of the national economy." Based on this principle, the Bank endeavors to conduct appropriate monetary policy in order to maintain medium- to long-term price stability. An explanation of how monetary policy contributes to price stability and the sound development of the national economy is given below.

At Monetary Policy Meetings (MPMs),[12] held once or twice a month, the Bank discusses and makes decisions regarding monetary policy, including the guidelines for money market operations. Currently, the Bank sets a target rate (policy interest rate) for the uncollateralized overnight call rate in its guidelines for money market operations.[13] The uncollateralized overnight call rate is one of the interest rates in money markets, where private financial institutions borrow and lend funds.

In order to meet the guidelines, the Bank works to influence the formation of interest rates in money markets by conducting various operations to make funds transactions with private financial institutions and adjust the supply and demand balance of funds in the markets. For example, in order to increase the amount of the supply of funds, the Bank provides loans to financial institutions against financial assets submitted as collateral (funds-supplying operations), and credits the funds to the counterparty financial institutions' BOJ accounts. Conversely, in order to decrease the amount of the supply of funds, the Bank sells, for example, its holdings of JGSs with repurchase agreements (funds-absorbing operations), and debits the funds from the counterparty financial

[12] MPMs are held by the Bank's Policy Board to decide on matters concerning the conduct of monetary policy (see Section B in Chapter II for the structure and procedures of the Policy Board).

[13] In contrast, there have been times when the Bank had employed a policy target other than the uncollateralized overnight call rate. For example, following the MPM in March 2001 until that in March 2006, the Bank set the outstanding balance of current accounts at the Bank as the policy target for market operations.

institutions' BOJ accounts. These types of operations to supply and absorb funds are called open market operations. Details of the frameworks of such operations, including these open market operations, are explained in Chapter V, "Market Operations."

In this way, the Bank influences money market interest rates, which in turn causes changes in the interest rates in other financial markets and those on bank loans to individuals and firms. As these changes in the interest rates influence economic entities' investment and consumption, the effect of monetary policy spreads to economic activity and prices (see Figure 1-2). For example, when the Bank raises the target for the uncollateralized overnight call rate, banks' lending rates rise, housing investments usually become restrained as mortgage rates rise, and firms' fixed investments become restrained. As a result, overall economic activity becomes restrained, exerting downward pressure on prices. On the other hand, when the Bank lowers the target for the uncollateralized overnight call rate, loan rates of banks usually fall, an increasing number of households apply for mortgages as the interest rates thereof fall, causing a rise in housing investments, and firms' fixed investments increase. As a result, overall economic activity picks up, leading to upward pressure on prices.

At MPMs, taking such a transmission mechanism of monetary policy into consideration, the Bank analyzes and assesses the current condition and prospects for economic activity and prices to decide on the guidelines for the policy. In addition to the control of money market interest rates, the Bank has implemented various policy measures according to the financial and economic situation. For example, when the functioning of financial markets was impaired significantly due to rapid contraction of financial and economic activities and anxiety about financial systems increased globally, as seen after the autumn of 2008, the Bank introduced measures to ensure financial market stability and to facilitate corporate financing[14] (see Box 4, "Global Financial Crisis after Summer 2007 and Policy Measures Taken by the Bank of Japan").

The Bank of Japan Act requires accountability as a counterpart to the

[14] In addition, since the Bank recognized that the most critical challenge the Japanese economy has faced was to raise the potential growth rate and productivity, it introduced a fund-provisioning measure to support strengthening the foundations for economic growth as a temporary measure in June 2010 in order to support, from the financial side, private financial institutions' efforts of their own accord toward strengthening the foundations for economic growth. The measure supplies long-term funds at a low interest rate against eligible collateral to financial institutions in accordance with their efforts in terms of lending and investment toward strengthening the foundations for economic growth. The duration of each loan is one year in principle, and the loan can be rolled over up to three times. The loan rate was 0.1 percent as of the end of 2010.

autonomy of the Bank in monetary policy.[15] Based on this fact, the Bank provides a wide range of information, not only because the Act stipulates the obligation of accountability, but also because it considers that clarifying to the public the content and process of the Bank's decision making regarding monetary policy leads to enhancing the effectiveness of monetary policy (see Box 2 for Chapter II, "The Bank of Japan's Measures to Strengthen Communication on Monetary Policy").

For example, the Bank released a public statement "The Introduction of a New Framework for the Conduct of Monetary Policy" in March 2006, and currently conducts its monetary policy based on this framework. The framework mainly consists of three elements: (1) the Bank's thinking on price stability; (2) examining economic activity and prices from two perspectives; and (3) outlining the current view on monetary policy.

The statement explained that, regarding the Bank's thinking on price stability, the Bank will review its basic thinking on price stability, and disclose an inflation rate level that its Policy Board members understand to represent price stability from a medium- to long-term viewpoint, in the conduct of monetary policy (the "understanding of medium- to long-term price stability;" hereafter, the "understanding"). The Bank will conduct monetary policy in the light of such thinking and such an "understanding."[16] In examining economic activity and prices from the two perspectives, the Bank examines and assesses economic activity and prices based on the following two perspectives: (1) as the first perspective, the outlook considered to be the most likely by the Bank as regards economic activity and prices around two years in the future; and (2) as the second perspective, various risks that are most relevant to the conduct of

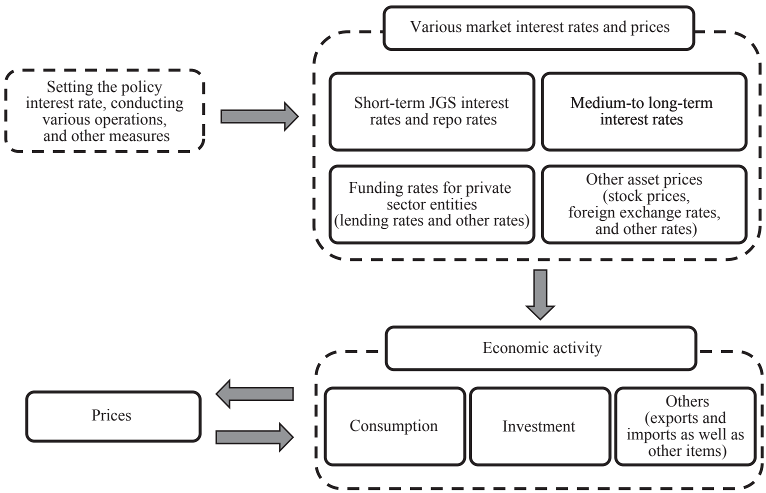
[15] Article 3, paragraph 2 of the Bank of Japan Act stipulates that "the Bank of Japan shall endeavor to clarify to the citizen the content of its decisions, as well as its decision-making process, regarding currency and monetary control."

[16] Price stability is the state where various economic entities, including households and firms, may make decisions regarding such economic activities as consumption and investments without being concerned about fluctuations in the general price level. Considering such elements as the measurement bias regarding the price index, the safety margin in the conduct of monetary policy, and firms' and households' views on prices, the "understanding" is expressed in terms of the consumer price index (CPI). Given that the "understanding," expressed in numerical terms, may change from time to time, reflecting structural changes in the economy and other developments, in principle, Policy Board members review it annually. The "understanding" examined in April 2010 shows that, on the basis of a year-on-year rate of change in the CPI, "each Policy Board member's 'understanding' falls in a positive range of 2 percent or lower, and the midpoints of most Policy Board members' 'understanding' are around 1 percent."

monetary policy over a longer term.[17] In outlining the current view on monetary policy, the Bank, in the light of deliberations from the two perspectives described above, outlines and discloses its view on the future conduct of monetary policy.

In order to appropriately conduct monetary policy as explained above and other business operations, including those to ensure financial system stability described later, it is very important to compile statistics, as well as to conduct research and studies, regarding economic activity and prices. These research and study activities are explained in Chapter VII, "Statistics, Research, and Studies." In addition, in order to accurately understand the economic and financial situation in Japan, it is necessary to consider the economic and financial situation abroad, as well as developments in global financial markets. In this aspect, the Bank maintains a close cooperative relationship with other central banks and international organizations, such as through exchanges of information and opinions related to research and studies. The Bank's international activities are explained in Chapter VIII, "International Operations and Services."

Figure 1-2 Transmission Mechanism of Monetary Policy



[17] In order to realize sustainable economic growth with price stability, it is necessary to examine and assess various factors, including the changes in asset prices and credit volume. In this context, from the perspective of the conduct of monetary policy, it is also important to take initiatives on the macroprudential front, in which risks inherent to the entire financial system are analyzed and evaluated, considering the interconnectedness of economic activity, financial markets, and the behavior of financial institutions (see Section C in Chapter VI).

3. Ensuring financial system stability

The term "financial system" refers to the entire system that is used to transfer or distribute funds and risks (the possibility of losses occurring) among economic entities such as firms and households. Financial system stability refers to the situation in which people can lend/borrow or accept/pay money with confidence. To maintain this situation, it is the key premise that financial institutions, which are an integral part of the financial intermediary function[18] and the payment and settlement function,[19] appropriately manage the risks related to these functions and soundly conduct their business.

In order to ensure and strengthen financial system stability, the Bank endeavors to identify actual business conditions of financial institutions by conducting on-site examinations and off-site monitoring, and advises them to improve their business activities if necessary. In on-site examinations, the Bank visits the offices of financial institutions that hold current accounts at the Bank, and in off-site monitoring, it analyzes various documents on financial institutions' business activities and interviews their executives and staff members. The Bank also organizes various seminars and publishes research papers in order to support financial institutions' activities that are aimed at improving management of risks and business activities.

However, in order to ensure the stability of the financial system, it is important to adopt not only measures based on the aforementioned microprudential perspective of identifying risks borne by individual financial institutions and encouraging improvement in their business activities, but also those based on the macroprudential perspective of analyzing and assessing risks by taking in the financial system as a whole. The Bank has been conducting risk analysis and assessment from the macroprudential perspective by taking in the financial system as a whole, while utilizing a wide range of micro information obtained through its activities. It utilizes the results of the risk analysis and assessment for conducting various policies and makes them public in the *Financial System Report*.

Despite the Bank's efforts to identify risks and encourage improvement in financial institutions' business activities from both microprudential and macroprudential perspectives, systemic risk can materialize. The term "systemic risk" is used to describe the possibility that the bankruptcy of a financial institu-

[18] The financial intermediary function is the function of smoothly and efficiently carrying out lending and borrowing of funds by mediating between lenders and borrowers.

[19] The payment and settlement function is the function of transferring funds and delivering securities associated with economic transactions conducted by financial institutions.

tion or disruptions in a particular market or a payment/settlement system will pose risks to other financial institutions, other markets, or ultimately the entire financial system, through a chain of disruptions[20] or dysfunctions.[21] In order to prevent the materialization of such systemic risk, the Bank will, when necessary, exercise its function as the lender of last resort and may provisionally provide necessary funds to financial institutions experiencing a temporary shortage of liquidity.

With the globalization of financial markets, a global approach to ensuring the stability of the financial system has become more important than ever. The Bank coordinates and cooperates with other central banks and the financial supervisory authorities by gaining consensus and exchanging opinions on financial system issues. The Bank also takes part in the international discussions to revise financial regulations. The business operations described above are explained further in Chapter VI, "The Bank of Japan's Business for Ensuring Financial System Stability," and in Chapter VIII, "International Operations and Services."

4. Provision of government-related services

As part of its banking services, the Bank accepts deposits from the government and provides various services related to the payment and receipt of the government's money (treasury fund services), such as the receipt of national taxes and payments for public works and pensions. The Bank also provides services related to the issuance and settlement of JGSs. These services are described in Chapter IX, "Treasury Funds and Japanese Government Securities Services." The Bank's intervention in the foreign exchange market, as the agent of the Japanese government, is explained in Chapter VIII, "International Operations and Services."

Following this chapter, which provides a summary of the book, Chapter

[20] The financial system consists of a network where many financial institutions transfer their funds. As they are involved in various credit/debt relationships, it is always possible for a chain of disruptions to occur.

[21] Systemic risk may materialize in such cases as follows: (1) a case in which a chain of payment failures occurs in payment and settlement systems and among financial institutions; (2) a case in which concern about the business conditions of an individual financial institution spreads to other financial institutions, resulting in a drain on deposits and market funds; and (3) a case in which a cautious attitude of market participants in transactions causes a drain on market liquidity and deterioration in market functioning, and, as a result, such disruptions spread throughout financial markets.

II explains the organization and management of the Bank, including the Policy Board, which is its highest decision-making body. From Chapter III onward, each business operation outlined in this chapter is explained in detail according to the respective field.

Box 1 Central Banks around the World

Most countries have a central bank, but the history of their foundation and organization structure depends on each country.

One prototype of central banks is the Bank of England (BOE), which was founded in 1694, by the subscription of people in the private sector, such as business people, mainly for the purpose of providing loans to the government. Following the depression of 1825, other private-sector banks began to deposit their reserves with the BOE, which led to the establishment of a payment and settlement system centered on the BOE. The Bank Charter Act of 1844 designated the BOE's banknotes as legal tender. In this way, the BOE became a central bank that was established as a result of the concentration of money issuance and interbank settlement in a single bank.

Another type, the Federal Reserve System of the United States, was established in 1913 by law. Under the Federal Reserve System, twelve regional Federal Reserve Banks provide central banking services, and member commercial banks hold stocks in one of the twelve Federal Reserve Banks. In Europe, the European Central Bank (ECB) was established in 1998 under a treaty and statute. In 1999, the eleven member states of the European Union agreed to issue a single currency, the euro. Currently, the ECB is responsible for conducting monetary policy for the member states that have adopted the euro, and the central banks in those countries conduct their operations according to the direction decided by the ECB.

Table for Box 1 The World's Central Banks

Year of foundation	Name	Country (currency)
1668 (the world's oldest)	Sveriges Riksbank	Sweden (krona)
1694	BOE	United Kingdom (pound sterling)
1882	Bank of Japan	Japan (yen)
1913	Federal Reserve System	United States (U.S. dollar)
1998	ECB	17 out of 27 European Union member states[1] (euro)

Note: 1. For the list of member states, see Figure 3-1 in Chapter III.

Box 2 The Three Functions of the Bank of Japan as a Central Bank

The following explains the Bank's functions as a central bank in each of the three categories: as the issuer of banknotes, the bank of banks, and the bank of the government.

(1) Issuer of banknotes

The Bank is the sole issuer of banknotes in Japan; that is, it has a monopoly on the issuance of banknotes. Article 46, paragraph 2 of the Bank of Japan Act stipulates that the banknotes "shall be legal tender and hence shall be used for payment without limits" (see Chapter III). Current banknotes in Japan are referred to as a managed currency that does not require being backed by the specie reserve for its issuance (see Chapter III.A.3).

(2) Bank of banks

The Bank receives deposits from private banks and other financial institutions in the Bank's current accounts (these deposits are referred to as BOJ accounts; see Chapter IV), and makes loans to these institutions (see chapters V and VI). Because the relationship between the Bank and private financial institutions is similar to that between banks and firms or individuals, the Bank is referred to as "the bank of banks." The funds transfer through BOJ account deposits is used to settle various financial transactions between financial institutions. Moreover, BOJ account deposits are used for the final settlement of credits and debts in private payment systems, including the Domestic Funds Transfer System, and the bill and check clearing system.

(3) Bank of the government

The Bank provides not only treasury funds services as its unique services based on relevant acts and ordinances but also some of the government's business services entrusted by the government, such as those related to Japanese government securities and foreign exchange. Therefore, the Bank is referred to as "the bank of the government" (see Chapter IX). However, Article 5 of the Public Finance Act prohibits the Bank from extending credit to the government (lending and underwriting Japanese government securities) in principle. Whether a central bank provides treasury fund services or not differs from country to country. Therefore, from the international perspective, it may not be common for a central bank to play the role of "the bank of the government."

Box 3 Monetary Policy Independence

In many countries, the government used to decide on monetary policy in pursuit of achieving price stability, or strongly influence the central bank's decisions. It is now common as a universal practice, however, for central banks, which are independent from the government, to conduct monetary policy. This major change began in the 1990s. Looking back at the history of central banks, it is easy for those conducting monetary policy to come under pressure to adopt inflationary policies. In fact, there are several cases where an increase in the issuance of money to cover government spending brought about severe inflation. Based on these experiences, in order to decide on monetary policy from a medium- to long-term viewpoint without any influence from the pursuit of short-term benefits, it is now common for central banks to conduct monetary policy independently.

With regard to this point, the Bank of Japan Act stipulates that, "the Bank of Japan's autonomy regarding currency and monetary control shall be respected" (Article 3, paragraph 1). Considering that monetary policy is conducted through the Bank's business operations, the Act also stipulates that, "in implementing this Act, due consideration shall be given to the autonomy of the Bank of Japan's business operations" (Article 5, paragraph 2).

The arrangements for ensuring the autonomy of the Bank are as follows.

- The terms of office for Policy Board members, including the Bank's Governor shall be five years (Article 24 of the Bank of Japan Act). The Policy Board is the highest decision-making body of the Bank.
- The Policy Board members shall not be dismissed against their will for the reason that they have a different opinion from that of the government (Article 25 of the Act).
- The budget for expenses of the Bank, submitted to the Finance Minister for authorization, is limited to those expenses specified by a Cabinet Order as not hampering currency and monetary control (Article 51 of the Act).
- Article 5 of the Public Finance Act prohibits the Bank from directly underwriting Japanese government securities in principle (see Section C in Chapter IX for the prohibition against directly extending credit to the government).

On the other hand, to ensure that the Bank's monetary policy and the basic stance of the government's economic policy are compatible, the Bank of Japan Act stipulates that the Bank shall "always maintain close contact with the government and exchange views sufficiently" (Article 4 of the Act). The Act also stipulates that representatives of the government may, when necessary, attend the meetings of the Policy Board during which monetary policy is decided (Monetary Policy Meetings), and express their opinions, submit proposals, and request that the Board postpone a vote on proposals until the next Board meeting (Article 19 of the Act). However, the government representatives have no votes in the monetary policy decision. Considering the opinions they express, the decisions are made by a majority vote of the nine Members of the Policy Board.

Box 4 Global Financial Crisis after Summer 2007 and Policy Measures Taken by the Bank of Japan

In the global financial crisis that emerged in the summer of 2007, the subprime mortgage problem, which began in the United States, became acute upon the involvement of Europe; this was first seen in the difficulty in funding conditions of European financial institutions. In addition to Europe and the United States, Japan also became caught up in the Lehman shock (described below), with global financial markets and financial systems malfunctioning, and economic activity taking a sharp plunge. The Bank and other central banks, in response to the situation, took various counter-measures in close cooperation. This box briefly explains the characteristics of the crisis, followed by policy measures taken by the Bank to counteract the crisis.

From 2002 to the summer of 2007, global financial activities, such as lending, expanded enormously, resulting in financial excesses featuring borrowing beyond solvency and excessive risk-taking. The financial crisis occurred in the process of the unwinding of this financial excess, triggered by the escalation of the subprime mortgage problem in the United States. In the crisis, the following three factors amplified the financial turmoil.

First, the pace of expansion in the flow of funds was much more rapid than that of growth in economic activity, resulting in the expansion of the global flow of funds at a faster pace than economic growth. As a result, market liquidity expanded significantly, and, accordingly, the subsequent contraction in liquidity and turmoil in financial markets became severe.

Second, financial institutions acting as intermediaries of the global flow of funds expanded their businesses, and came to take on higher liquidity risk.[1] In particular, European financial institutions significantly expanded their businesses by using short-term U.S. dollar funds raised from other banks to invest in long-term financial products for nonfinancial institutions. As a result, the liquidity risk intensified because of the maturity mismatch between short-term funding and long-term investment.

Third, over the decade leading up to 2007, the global flow of funds expanded along with the increase in financial network density. The network among banking sectors had become closely linked in terms of both the number of counterpart countries and the value of financial transactions. Therefore, the stronger links in the financial network contributed to effectively allocating the gain from the economic growth throughout the world until 2007. Conversely, in the financial crisis since 2007, the shock of the turmoil in the U.S. subprime mortgage loan market quickly spread beyond U.S. borders throughout the network, leading to the difficulty in U.S. dollar funding for European financial institutions.

In response to the sharp decline in the liquidity of U.S. dollar funds in each country beyond the U.S. border, the central banks of various countries closely cooperated with one another and took coordinated action. For example, as a measure to counteract the crisis, they raised U.S. dollar funds from the Federal Reserve and provided the funds to their own financial markets. Supported by such efforts of central banks, in the middle of 2008, global financial markets gradually regained stability.

However, triggered by the failure of Lehman Brothers, one of the large investment banks in the United States, in the autumn of 2008 (referred to as the Lehman shock), the turmoil in global financial markets spread quickly, affecting Japan and emerging economies as well. Especially in European and U.S. financial markets, since financial institutions, as market participants, grew concerned about the default risk of their counterparties and became cautious about lending to other financial institutions, liquidity evaporated and anxiety about financial systems intensified sharply. In addition to the concern over liquidity, financial institutions and investors — concerned about the capital shortage caused by huge losses from securitized products and other financial products — lost their risk appetite and raised their standards for lending and investment. As a result, the credit intermediary function related to corporate finance, such as corporate bond and CP markets as well as bank loans, deteriorated, making funding difficult for firms. The financial contraction worked as a strong restraint on economic activity. With the instability of the financial system as the background, anxiety about the financial system intensified globally, and financial and economic activities deteriorated while creating a negative feedback effect between them.

Based on such a situation, central banks took several measures, including: (1) the lowering of the policy interest rate; (2) the provision of liquidity of their own currency and U.S. dollar funds to ensure the stability of financial markets; and (3) the expansion of the range of assets in outright purchases of their market operations aimed at recovering the financial market function and the financial intermediary function of financial institutions (referred to as “credit easing”).

In Japan, especially since the Lehman shock, it became extremely difficult to issue corporate bonds and CP, and the function of the U.S. dollar-yen swap market, where Japanese financial institutions raised U.S. dollar funds, seriously deteriorated. Under these circumstances, the Bank conducted various measures to support the Japanese economy from the monetary policy side. These measures included: (1) the lowering of the policy interest rate in two stages — in October and December 2008 — to 0.1 percent; (2) measures to ensure the stability of financial markets; and (3) measures to facilitate corporate financing (see Table below).

Specifically, in order to ensure financial market stability, the Bank provided ample liquidity to financial markets by actively utilizing various funds-supplying operations and by expanding the range of corporate debts as its eligible collateral for market operations. In addition, the Bank raised U.S. dollar funds from the Federal Reserve based on the temporary U.S. dollar liquidity swap agreement, and directly provided the funds by conducting a U.S. dollar funds-supplying operation against pooled collateral[2] in coordination with other central banks (see Section F in Chapter V).

In order to facilitate corporate financing, the Bank introduced: (1) special funds-supplying operations to facilitate corporate financing for extending loans to the counterparties of the operations up to three months for an unlimited amount within the value of the corporate debt the counterparties submitted to the Bank as collateral; and (2) outright purchases of CP[3] and corporate bonds[4] directly from the counterparties of the operations. The outright purchases of CP and corporate bonds were exceptional as central bank policy measures in that the Bank itself purchased the debt of private firms.[5] Therefore, the Bank clarified the basic principles regarding the outright purchases of corporate financing instruments, and conducted these operations considering the following: (1) preventing the purchases from functioning as arbitrary funds allocation among individual firms; (2) conducting the purchases only for a required period and in appropriate scales; and (3) ensuring the Bank's financial soundness.[6]

Meanwhile, in terms of ensuring financial system stability, the Bank also conducted measures that were unconventional for a central bank, while giving due consideration to maintaining its own financial soundness. Specifically, in February 2009, the Bank decided to resume purchases of stocks held by financial institutions in order to encourage them to cope with the risk associated with stockholdings, which is a critical business challenge for financial institutions in Japan. The Bank continued these purchases until the end of April 2010. In April 2009, the Bank decided to provide subordinated loans to financial institutions. This measure was aimed at ensuring the smooth functioning of financial intermediation, by enabling Japanese financial institutions to maintain sufficient capital bases. The Bank held four auctions for subordinated loans during fiscal 2009 (see Chapter VI.D.2).

Notes: 1. For details on liquidity risk, see Figure 6-1 and Chapter VI.F.3.b.
2. The temporary U.S. dollar liquidity swap agreement with the Federal Reserve and the U.S. dollar funds-supplying operation against pooled collateral expired once in February 2010. However, responding to the intensified strain in U.S. dollar financial markets in Europe due to the fiscal problem in Greece, the Bank resumed them as temporary measures in May 2010.
3. The CP to be purchased were those eligible to be pooled collateral of the Bank, rated a-1 or higher, and issued before or on the auction date with a remaining maturity of up to three months.
4. The corporate bonds to be purchased were those eligible as the Bank's collateral, rated A or higher, with a residual maturity of up to one year at the end of the month in which the purchase was conducted.
5. For the Bank's assets and capital base, see Box 4 in Chapter II, "Basic Accounting Principles for the Bank of Japan's Balance Sheet."
6. Outright purchases of CP and corporate bonds, and special funds-supplying operations to facilitate corporate financing, which had been introduced as temporary measures, expired one by one from the end of 2009 to the end of March 2010, as financial markets gradually regained stability.

Table for Box 4 Global Financial Crisis and Policy Measures Taken by the Bank

August 9, 2007	- BNP Paribas froze its affiliated funds (the so-called BNP Paribas shock).
March 16, 2008	- JPMorgan Chase acquired Bear Stearns to rescue it from bankruptcy.
September 15, 2008	- Lehman Brothers failed (Lehman Brothers Holdings filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. The failure is referred to as the Lehman shock). - Bank of America announced the acquisition of Merrill Lynch.
September 16, 2008	- The U.S. government announced the bailout of American International Group (AIG), the largest insurance company in the United States.
September 18, 2008	- The Bank, together with other central banks, announced coordinated measures (the conclusion of a U.S. dollar swap agreement with the Federal Reserve, or an increase in the maximum aggregate amount of the U.S. dollar swap facility) designed to address the elevated pressures in U.S. dollar short-term funding markets. The Bank decided to conclude a U.S. dollar swap agreement with the Federal Reserve, and introduce a U.S. dollar funds-supplying operation (both the agreement and operation expired in February 2010 but resumed in May 2010).

September 29, 2008	- The Bank, together with other central banks, announced additional coordinated actions (an increase in the maximum aggregate amount of the U.S. dollar swap facility) to expand the capacity to provide U.S. dollar liquidity. The Bank expanded the U.S. dollar funds-supplying operation.
October 14, 2008	- The Bank introduced a U.S. dollar funds-supplying operation against pooled collateral, whereby funds are provided at a fixed rate set for each operation for an unlimited amount against pooled collateral. - The Bank decided to suspend selling stocks purchased from financial institutions on the stock exchanges.
October 31, 2008	- The Bank decided to lower the policy interest rate from 0.5 percent to 0.3 percent and introduce a complementary deposit facility.
December 2, 2008	- The Bank introduced measures of market operations to facilitate corporate financing.
December 19, 2008	- The Bank decided to lower the policy interest rate from 0.3 percent to 0.1 percent, and decided on additional measures such as increasing the amount of outright purchases of Japanese government securities and introducing a special funds-supplying operation to facilitate corporate financing (the operation expired at the end of March 2010).
January 22, 2009	- The Bank announced the basic principles regarding outright purchases of corporate financing instruments and decided on measures such as introducing outright purchases of CP (the purchases expired at the end of December 2009).
February 3, 2009	- The Bank resumed purchases of stocks held by financial institutions (the purchases expired at the end of April 2010).
February 19, 2009	- The Bank decided to expand measures to facilitate corporate financing (such as by introducing outright purchases of corporate bonds which expired at the end of December 2009).
March 18, 2009	- The Bank increased the amount of outright purchases of Japanese government securities.
April 10, 2009	- The Bank decided to provide subordinated loans for financial institutions (this measure expired at the end of March 2010).
May 22, 2009	- The Bank decided to accept eligible foreign bonds as collateral (so-called cross-border collateral) for the Bank's market operations.