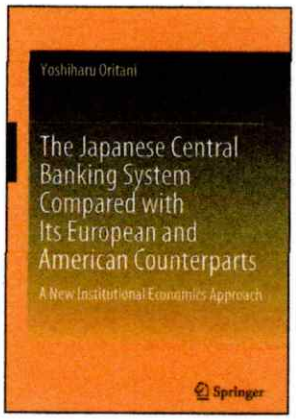

Yoshiharu Oritani, **The Japanese central banking system compared with its European and American counterparts: a new institutional economics approach**, Springer, 2019, 352 pages

This book has no equal in comprehensively reviewing the implications of new microeconomic theory for central banking. In his foreword, former Bank of Japan governor Masaaki Shirakawa identifies three dimensions of the widening "perception gap between the central bank as I understand it and as it is presented in books": there is too little analysis of the creation of deposit money; the actual transactions undertaken to implement monetary policy should be given more attention; and a central bank is an organisation as any other – where governance mechanisms shape behaviour, and where the internal ethos and morale is often decisive in determining effectiveness.

This book tackles this gap by applying new institutional economics (NIE) to the whole range of central bank policies. The economics of transaction costs, of information and of agency function – which microeconomists have developed with such imagination in recent decades – is key to this endeavour. Because of its comprehensiveness and the clarity of its summaries of these new theories, this book is likely to become a lasting reference. This is aided by the very methodical layout, the extensive bibliography (including many Japanese publications, whose key points are summarised in the text) and a good index.

No-one is better qualified to write such a book than Yoshi Oritani: a 30-year career at the Bank of Japan and extensive international engagements (notably on the Bank for International Settlements' Committee on Payment and Settlement Systems, and work with the Executives' Meeting of East Asia Pacific central banks, better known as EMEAP). He was already thinking hard (and talking a lot!) about the theory of central banking systems in the mid-1980s when I first met him at the BoJ's Institute for Monetary and Economic Studies. He continued to delve deeply into this subject during his decade as a professor at Meiji University.

What might NIE say?

He addresses almost all the major controversies of central banking. He does so by asking two questions: "What might NIE have to say? What are the counterarguments?" He rightly has strong opinions, but lays out the opposing case fairly. For instance, he argues that interdependencies and the use of common production factors make it efficient (in the sense of minimising transaction costs) to integrate monetary policy with exchange rate policy. Yet the objectives of these two policies can conflict (tighter monetary policy might make the exchange rate uncompetitive), so the issue of priority-setting remains. The mutual dependencies between monetary policy and prudential policy are many, and the complexity of the information needed to conduct either is so great that making one institution responsible for both has great transactional efficiencies. However, large organisations are subject to groupthink (analysis challenging their prejudices is stifled), breed excessive bureaucracy and concentrate power in dangerous ways.

The chapter on financial crisis management by the US authorities provides fresh insight into this well-worn topic. He does this by combining a careful account of the missteps of the authorities with an exposition of the failures of three intellectual perspectives: neoclassical economics; behavioural economics; and transaction cost economics. He is surely right that the crisis revealed shortcomings in the operation of the lender-of-last-resort (LLR) function of central banks. The dividing line between liquidity and solvency shifts with financial conditions (including the value of collateral and the willingness/ability of banks to lend). Even a decade later, it is still an open question whether Lehman Brothers was solvent but illiquid when the US authorities allowed it to fail. Those deciding on that fateful weekend faced an almost impossible task.

Risk-taker of last resort

Oritani argues that central banks need to go beyond the Walter Bagehot LLR framework and be ready to be the risk-taker of last resort. Because it would take too long to persuade the legislature in a crisis of the need for capital injections from the Treasury, he argues, the central bank should step in. To meet such demands, central banks should accumulate their seigniorage profits, and not distribute regularly to governments. He draws on James Buchanan's theory of earmarked taxes: tying resources for saving the financial system to central bank profits serves to compartmentalise fiscal decisions in a rational way. There are, of course, arguments against such reasoning, but the inadequacy of current LLR provisions is a live issue.

Common organisational culture

His section on the value of a fit-for-purpose common organisational culture in a central bank is especially insightful. Shirakawa is quoted on the importance of a culture that respects both research and banking activities. Fundamental and theoretical research helps communication between central banks. It can counter groupthink, the biggest threat to objective policy advice. Critical and out-of-the-box thinking is also required of prudential policy. It was in the BIS's Basel Committee on Banking Supervision that the idea of 'macro-prudential' policies first surfaced (in 1979). It did not come from economists. A culture in central banks that is too dominated by 'macroeconomic types' who do not understand the banking sector can be dangerous. Macroeconomists who love simple aggregate statistics that are easy to calculate for all countries (which makes for publishable research papers) so often fail to identify genuine systemic threats. Those actually responsible for prudential policies can laugh or cry about this, depending on their mood. Banking, economics and prudential oversight – getting the specialists of these different subjects to work effectively together in a central bank is not straightforward.

> ***"Oritani addresses almost all the major controversies of central banking. He does so by asking two questions: "What might NIE have to say? What are the counterarguments?""***

The chapter on the governance of payment and settlement systems is excellent. He has brought it up to date by considering what is new and what is old. He proposes central banks offer multi-currency settlement services. The central bank is the organisation best placed to offer e-money that is highly interdependent with monetary policy and that has links with financial stability.

Anyone interested in central banking will enjoy this book – brimming with original thoughts expressed with the author's characteristic verve. ❑

Philip Turner