BOJ Raises Key Rate on Split Vote

– Giving Priority to Rate Normalization –

By Aoki Masaru

THE Bank of Japan's Policy Board decided by a majority vote of eight to one on Feb. 21 to raise its target for the uncollateralized overnight call rate by a quarter percentage point to 0.5%. The hike, which took effect immediately, was the first in seven months since the central bank ended its zero-interest rate policy and increased the rate last July for the first time in some six years. The policy rate target of 0.5% is the highest level in about eight years and a half since September 1998, when it was lowered from 0.5% to 0.25%.

Most of the nine Policy Board members judged that consumption and price trends, which had been a matter of concern to them, were likely to improve, clearly indicating their intention to give priority to normalizing the level of interest rates. If interest rates remained at extremely low levels for a prolonged time, BOJ Governor Fukui Toshihiko told a press conference, financial and economic activities could go to extremes, resulting in funds and resources being misallocated and thereby hampering sustained economic growth. The Policy Board comprises the BOJ governor, two deputy governors, and six former businesspersons and scholars.

The BOJ also increased its basic interest rate on loans to financial institutions under the so-called "complementary lending facility" to 0.75% from 0.4%. When the central bank terminated the zero-interest rate policy last July, it limited a hike in the basic rate, known formerly as the official discount rate, to 0.15 percentage point in a bid to ease any impact of an interest rate increase. In February, however, the BOJ expanded this rate's deviation from the call rate target, placing priority on the recovery of money market functions. Meanwhile, the central bank decided to continue outright purchases of government bonds at a monthly pace of ¥1.2 trillion to help prevent long-term interest rates from rising.

At the Feb. 21 Policy Board meeting, Governor Fukui made a rate-increasing proposal in a manner to reflect a majority view among the nine board members. But Deputy Governor Iwata Kazumasa alone voted against the proposal, voicing his concern about future price trends. This represented the first division of opinion among the three-man BOJ leadership since a new BOJ law took effect in 1998. Since the February meeting, the BOJ has begun publishing how each board member voted.

Commenting on the conclusion of board discussions on the outlook for Japan's economy, Governor Fukui said after the board meeting the bank judged that "in all probability our economy is likely to continue its moderate expansion with a virtuous circle of production, income and spending in place." On personal consumption, he said: "The decline observed last summer seems temporary, and it is judged to be on a moderately increasing track." Personal consumption in the October-December quarter of last year scored an inflation-adjusted real increase of 1.1% from the previous quarter to offset a 1.1% drop in the July-September quarter, as indicated by gross domestic product (GDP) data that came out on Feb. 15 before the BOJ monetary policy meeting. The data also included a substantial real GDP growth rate of 1.2%, annualized at 4.8%, in the final quarter.

On the core consumer price index that excludes prices of perishables, which has been registering small year-on-year increases, Fukui said, "It is possible that the rate of change will be in the neighborhood of zero in the short run, depending, for example, on developments in crude oil price trends." But he retained the previously announced projection that consumer prices are likely to continue their rising trend against the backdrop of rising capacity utilization of resources such as equipment and labor and anticipated continuation of economic expansion.

"Given the prospects of the economic and price situations improving, the stimulative effect of monetary policy could be expected to gradually increase if the policy interest rate were kept at the current level," Fukui said. "If the expectation takes hold in such circumstances that interest rates will remain low for a long time regardless of economic and price situations, there may arise a possibility that the flow of funds and the distribution of resources will be distorted by excessive financial and economic activities, thus hampering sustained economic growth." Therefore, he said, the central bank judged that "it is appropriate to adjust the level of interest rates at this juncture."

With regard to the future course of monetary policy, the central banker indicated that the BOJ will seek to boost interest rates gradually to their "normal" levels.

"We will eventually adjust the level of interest rates gradually in the light of developments in the economic and price situations while maintaining for some time the accommodative financial environment ensuing from the very low interest rates."

At the Feb. 21 board meeting, on the other hand, government representatives refrained from asking for postponement of a vote on the rate-increase proposal. On the day when the BOJ made the decision, Prime Minister Abe Shinzo told reporters the government would respect the BOJ judgment. "I believe that the BOJ has responsibly made an appropriate decision, taking into account the present price and economic situations and risks," he said. "Any monetary policy decision is up to the BOJ." Within the government and ruling parties, some people voiced persistent objection to an interest rate hike, while others cautioned against any political intervention in monetary policy. The government appears to have concluded that due consideration should be given to the BOJ's independence.

At her press conference on the same

day, however, Economic and Fiscal Policy Minister Ota Hiroko gave a written press release quoting a government representative at the BOJ meeting as saying that the time was not ripe for the BOJ to hastily raise interest rates as the Japanese economy had yet to get out of deflation, with consumption remaining weak. When the October-December GDP data was published, Ota indicated a cautious view about the first rise in two quarters in personal consumption. ‘’This means a leveling-off for the two quarters combined and still indicates a weakness.’’

It is unusual for the government to publish such a written press release summarizing a government representative’s remarks at a BOJ policy meeting before the central bank announces the minutes of a meeting. By emphasizing the fact that the government opposed an interest rate hike, the government apparently indicated that the BOJ should be held responsible for any future economic deterioration. Ahead of a triennial House of Councillors election set for this summer, the release reflected the Abe Cabinet’s dissatisfaction with the interest rate hike that could affect its growth-emphasizing strategy. In this sense, the latest rate increase may cause friction between the central bank and the government and ruling parties.

A possible interest rate increase was also taken up at the previous BOJ policy meeting that took place on Jan. 18. The board turned down a rate hike proposal by a vote of six to three. According to the minutes of the January meeting as released in late February, three board members – Suda Miyako, Mizuno Atsushi and Noda Tadao – made the proposal for a quarter-point hike in the uncollateralized overnight call rate target, warning that the maintenance of extremely low interest rates could risk too much economic stimulation. But the other six board members voted against the proposal, including Governor Fukui who had been expected to submit a rate-increasing proposal at the January meeting.

The BOJ’s low interest rate policy has increased the risk of a recurrence of economic bubbles as seen in the late 1980s. Real estate transactions in central Tokyo have been overheated, while the Nikkei stock average has more than doubled from a post-bubble era low of 7,607 posted in April 2003.

In addition, Japan’s extremely low interest rates have been cited as contributing to excess liquidity in the global financial market. The policy interest rate stands at 5.25% in the United States and 3.5% in the euro currency zone. The wide gaps between Japanese interest rates and those in the United Sates, Europe and emerging economies have prompted financial market players to borrow yen funds at low rates for investment in high-rate currencies in the “yen carry trade.” At a February meeting of top financial officials from the Group of Seven industrial countries, European delegates voiced complaints against the yen’s weakness attributable to low Japanese interest rates.

Since last year, BOJ head Fukui has been seeking to raise interest rates for the normalization of monetary policy. “We should take a further step toward normalization,” he has reiterated since last year. Fukui emphasized the need for monetary policy normalization again at the press conference after the February rate hike. “Although prices are very low, the relative interest rate level of 0.25% or 0.5% is rather extremely low even if a real economic growth rate is supposed to remain stable at around 2%.”

In fact, the BOJ had once been believed certain to raise interest rates at its January monetary policy meeting. On Jan. 14, just before the Jan. 17-18 meeting, however, the ruling Liberal Democratic Party’s Secretary General Nakagawa Hidenao threatened to urge the government to request postponement of a vote on a rate-increasing proposal. “We see no reason for the BOJ to change its policy this month after giving up a decision to raise interest rates in December last year,” Nakagawa said. As he and other senior government and LDP officials voiced their opposition to a possible rate hike, the BOJ finally gave up a rate boost. The central bank was then criticized for succumbing to political pressure after Prime Minister Abe defended BOJ chief Fukui when the governor came under fire last year for retaining personal investment in a fund managed by a disgraced Japanese fund manager, Murakami Yoshiaki, suspected of insider trading.

Photo: PANA

A shopper watches TV screens as Bank of Japan Governor Fukui Toshihiko announces a hike in the central bank’s policy interest rate in a live press conference.

The view was growing then that it would be difficult for the BOJ to raise interest rates until this summer’s House of Councillors election. But the central bank managed to defend its once shaken prestige by making the decision to raise interest rates at the February board meeting. Japan is plagued with the most serious budget deficit among industrial nations and has little room to increase fiscal spending to stimulate the economy. In this sense, it is very significant for the central bank to secure some room to lower interest rates for future economic stimulation.

But the BOJ’s rate hike decision has had a problem regarding the central bank’s “dialogue” or communication with the market. Since the BOJ refrained from increasing rates at its January meeting despite dominant financial market expectations of a rate boost, the central bank has had difficulties in making a smooth dialogue with the market. Although media reports predicted a rate increase ahead of the January board meeting, there were few such reports before the February meeting. As a result, market players were divided over whether the BOJ would raise interest rates at the February meeting. The rate hike thus failed to be discounted into the market sufficiently. This is taken as indicating that the BOJ and the market differed over interpretation of the economic and price situations. The central bank may have to review its information strategy in order to normalize its communication with the market. JS

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