

# The Bank of Japan Expands Quantitative Easing to Dispel Concern about Deflation

By Tani Sadafumi

At the Monetary Policy Meeting of its Policy Board on Aug. 13 and 14, the Bank of Japan (BOJ) decided by a majority to expand the quantitative monetary easing it embarked on in March. At the press conference after the meeting, BOJ Governor Hayami Masaru expressed the Bank's determination to dispel concerns about deflation and to support structural reform from a monetary standpoint, saying "With this monetary policy, the BOJ showed firm resolution to stop falls in prices by all means and fix the basis of economic revival," and "the aim is to inspire people with hope." On Aug. 14, the Nikkei Stock Average and TOPIX showed a recovery due to the BOJ's decision, but afterwards they both slipped to their lowest levels since the collapse of the bubble economy. Among the government and ruling parties, there rose a demand for further monetary easing as quickly as possible.

The BOJ's policy of quantitative easing is intended to help achieve the objective of guiding the financial institutions' current deposits with the BOJ from ¥5 trillion to ¥6 trillion. As a specific measure, the BOJ increased the amount of the outright purchase of long-term government bonds from the current ¥400 billion to ¥600 billion per month. The BOJ described its analysis of the Japanese economy in a written statement – "Cyclical economic adjustment is deepening further," and "it is believed that weak demand may cause prices to decline more." The statement added – "The quantitative easing policy was decided on because, after taking account of the severe economic and price conditions and future prospects, it is necessary and proper to reinforce the support of economic recovery from the monetary side within the framework of the monetary policy decided in March."

Let me give a simple overview of the mechanism of the quantitative easing policy. Financial institutions have interest-free current deposits at the BOJ

for the settlement of accounts. Under the reserve deposit system, the minimum deposit required is about ¥4 trillion. Financial institutions raise funds for the shortages from the short-term money markets. If the BOJ, through its operations, supplies the short-term money markets with more funds than are required by the financial institutions, the excess funds will flow into the financial institutions' current deposits. In March, the objective for the financial institutions' current deposits was set at ¥5 trillion. This time, in August, the objective was set at ¥6 trillion, which is ¥1 trillion higher than the previous amount. This measure also has the effect of keeping the interest rates in the money markets at nearly zero-percent.

As a result of this policy, financial institutions will have ready funds on hand, and they will lend out surplus money or buy government and corporate bonds, because it is useless for them to retain funds that do not yield interest. If the funds circulate throughout Japan in this manner, economic activity will be revived and deflationary trends will brake. This is the effect of the quantitative easing policy that the BOJ is expecting.

The actual economic situation, however, may not work as we expected. According to the BOJ's statistical data on the trends of loans and funds collections, after quantitative easing in March, the loans of city and regional banks for the April-June period decreased 3.7% year-on-year, and those for July decreased 4.0% year-on-year, which is a continuous reduction. The banks cannot lend out their surplus money, in spite of their intent, because the demand for business loans is sluggish. Economists are divided in their opinions on the expansion of quantitative easing in August.

Shimanaka Yuji, the Chief Economist at Sanwa Research Institute and Consulting Corp., evaluating the

Bank's August measure, said, "The expansion of quantitative easing will cause expectations of increasing investment intentions and help boost Japan's economy by an indirect effect through the market." He also indicated the necessity of further reinforcement of monetary easing. On the other side, Yamazaki Mamoru, Chief Economist at Barclays Capital, takes a skeptical view saying "It cannot be safely assumed that credit will be created while financial institutions and business corporations are still balancing their accounts, and it is natural to assume that the direct effect of quantitative easing on the economy will be limited." Also, the BOJ itself regards the quantitative easing policy as an "experiment unprecedented in history (according to an executive of the BOJ)" and is not sure how much the easing policy will support the actual economy.

The BOJ decided to expand the quantitative easing against the background of the receding Japanese economy. The recession can be clearly traced in the government's monthly economic reports. The tone for business was reported to "continue to rise modestly" in January, but was revised downward step by step. The expression "deteriorating" appeared for the first time in the report for June and was changed to "further deteriorating" in the report for August. As it has become clear that adjustment of the U.S. economy would take longer than expected, there are signs of a decline in exports, which are Japan's only hope. Corporations have started holding back from not only capital investment but also production activities. As a result, the economy is entering a trend toward cyclical contraction, in which income and employment environments get worse and personal consumption stagnates.

Regarding prices, the wholesale price indexes in the 10 consecutive months up to July and, more surprisingly, the consumer price indexes in the 22 con-

secutive months up to July were below the comparable figures last year. This lowering of prices has been partly caused by a beneficial fall in prices due to structural reforms and industrial competition, especially in the distribution sector, but recently there has been a remarkably unfavorable fall in prices due to sluggish demand. For this reason, there is rapidly increasing concern among many economists that there will be a fall into a deflationary spiral.

Under these circumstances, debate about policy measures tends to be not about the budget and tax system but about taking monetary policy measures which are more maneuverable. Especially, in the present political situation, in which Prime Minister Koizumi Jun'ichiro is promoting financial reconstruction as part of structural reform, limits are set on the employment of fiscal operations. As a result, the BOJ is under pressure from economists both inside and outside Japan, as well as the Japanese government and ruling parties.

The economic ministerial meeting for the monthly economic report held on Aug. 10, several days before the Monetary Policy Meeting, seemed like a place for battering the BOJ. Aso Taro, Chairman of the Policy Research Council of the Liberal Democratic Party (LDP), triggered the battering by saying, "The BOJ should bear the responsibility for falls in prices. Simple continuation of the present monetary policy (quantitative easing decided in March) is inadequate." Finance Minister Shiokawa Masajuro followed by directly requesting the BOJ to consider additional monetary easing, saying, "The government has emphasized the need to stop the fall in prices many times. The BOJ should take the government's request seriously." LDP Secretary General Yamasaki Taku said, "I feel that monetary easing has not taken effect," expressing a distrust of the BOJ, which has not taken any new measures since March.

With this political pressure, many market-related parties expected that the BOJ would probably be forced to decide on additional quantitative easing in September. Therefore, the BOJ's decision in August surprised the mar-

ket. It can be said that the BOJ's measure was successful from a standpoint of the effectiveness of the announcement.

The effect of the announcement seemed to be one of the reasons why the BOJ took action earlier than the market expected. Furthermore, the BOJ seemed to attach great importance to the fact that the gross domestic product (GDP) for the April-June quarter would be announced on Sep. 7. Every think-tank expected a decrease in GDP (the GDP actually decreased 0.8% from the previous quarter, which is a 3.2% decrease in annual growth), and if the BOJ hesitated to take action and waited for the announcement of the GDP, it would naturally expose itself to stronger pressure.

A summary of the proceedings of the Monetary Policy Meeting in July was made public on Aug. 17. According to the summary, although no changes in monetary policy were decided, many members at the meeting pointed out that "Should there be a risk of financial market instability, ... the Bank will provide ampler liquidity..." Also, some members alluded to the need for "setting a higher target for the outstanding balance of current accounts at the Bank" and "enhancing money market operations, by for example increasing the outright purchase of JGBs [Japanese government bonds]." The contents of this summary should increase public expectations as a matter of course after the publication. If the BOJ wanted to show that it acted according to its own judgment and surprise people, it could not wait until September to make a policy decision.

However, even after the expansion of quantitative easing in August, the political pressure on the BOJ seems to have increased. Masuzoe Yoichi, who was elected as a member of the Upper House by heading the polls in July, has established a committee to study a revision of the Bank of Japan Law together with House of Representatives members Yamamoto Kozo and Watanabe Yoshimi, with the aim of giving the prime minister the authority to remove the BOJ Governor from office. The committee has proposed the introduction of "inflation targeting," which sets

targets for price increases and implements monetary policies to achieve them. This movement is based on a distrust of the BOJ, whose independence is asserted by law.

In addition to these three people, many people in the government and ruling parties and many economists support the introduction of inflation targeting. Some countries have adopted this measure to suppress a rise in prices, but most of these supporters, in particular House members, seem to regard it simply as a measure for inflation adjustment.

The BOJ, on the other hand, has considered studying inflation targeting as a way to suppress inflation, but it has denied introducing it to adjust inflation for the reason that inflation is uncontrollable once it starts accelerating. At the press conference held after the Aug. 14 meeting in which the expansion of quantitative easing was decided on, Hayami spurned the introduction of inflation targeting saying, "Taking measures recklessly to reach an inflationary target, such a crazy monetary policy is impossible." These words upset the politicians who have opposed the BOJ, having caused controversy on this subject to become an emotional issue. **JTI**

*Note:* In response to the recent terrorist attacks in the United States, the Bank of Japan took the following emergency measures on Sep. 18: (1) The target for current deposits was raised from "approximately ¥6 trillion" to "over ¥6 trillion" and (2) the bank rate was lowered to 0.10% annually from 0.25% annually. Financial institutions that temporarily fall short of funds can now borrow at an even lower interest rate because the bank rate is used for the supplementary loan system financed by the BOJ to meet the needs of financial institutions.

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