BOJ Abandons Quantitative Easing Policy for the First Time in Five Years

– Expectations of Interest-Rate Hike this Summer Grow Stronger –

By Aoki Masaru

AT a Monetary Policy Meeting of the Bank of Japan (BOJ) Policy Board held on March 8-9, 2006, the BOJ decided to end the monetary easing policy in effect since March 2001, lowering its target for the outstanding balance of current account deposits held by private financial institutions, and returning to an interest-rate policy that uses the unsecured overnight call rate as the monetary adjustment target. The zero interest-rate policy, which was a measure unprecedented anywhere in the world, was ended after five years in consideration of the halt of deflation and a steady recovery in business conditions. Even after ending the policy, the BOJ is maintaining a monetary policy of "encouraging a virtual zero interest rate" with the unsecured overnight call rate as the monetary adjustment target, and the point at which this policy will be terminated is the new focus. Market expectations that the BOJ will raise interest rates this summer for the first time since August 2000 are growing stronger.

The BOJ's Monetary Policy Meeting is attended by nine members with voting rights. These are the Governor, two Deputy Governors, and six other members, all of whom have equal voting rights. The policies are decided by majority vote. Representing the government are top officials from the Cabinet Office and the Ministry of Finance, who do not have voting rights but may offer opinions and request that a decision be deferred until the next meeting.

Following the March 9 Monetary Policy Meeting, the BOJ announced that seven members voted in favor of ending quantitative easing, one voted against, and committee member Fukuma Toshikatsu was absent. In addition, it was announced that, following a thorough review of conditions in the short-term money market, the outstanding balance of current-account deposits would be reduced over several months from the ¥30-35 trillion level to the ¥6 trillion level.

On the other hand, it was also announced that the purchase of long-term government bonds will remain at the same level of investment and frequency (¥1.2 trillion per month). Under pressure from financial institutions, the official discount rate for Lombard lending, as well, will in principle be kept at the current reference rate (0.1%). Together with this, a policy was hammered out to continue the temporary expedient adopted in March 2003 of not specifying a limit on the number of days of usage. Further, with regard to future monetary policy management, it is thought, "It is highly possible that an easy money environment will keep interest rates at extremely low levels."

In addition, as a "new monetary policy management framework," the Policy Board has announced an inflation rate considered to equate with a stable cost of living over the medium and long term. At present, the members of the Policy Board share the view that if the rate of increase in the consumer price index (CPI) in comparison to the previous year is 0 to 2%, this can be seen as being within the scope of medium and long-term price stability, and their median value is generally 1%.

When the BOJ introduced its quantitative easing policy in 2001 to halt the advance of deflation, it was with the clear promise that the policy would continue until the nationwide CPI, excluding fresh produce, stabilized at an annual comparison of zero or higher. In the statement released after this March's policy meeting, it points out with regard to the Japanese economy that a "sustained recovery is forecast." In addition, the statement says with regard to prices, "It can be seen that a year-on-year rising trend in the CPI will be established," and goes on to say that, "As a result, we judge that the conditions of the 'promise' have been fulfilled." Last October the nationwide CPI, excluding fresh produce, was unchanged from a year earlier, and November and December showed continuous growth of 0.1%. The scope of the increase rose to 0.5% this January.

The summary of the March Monetary Policy Meeting released in April referred to the process of reaching the decision to end the easy monetary policy. On the second day of the meeting, BOJ Governor Fukui Toshihiko compiled many opinions into a proposal for ending the easy monetary policy, and a vote was taken. The only vote against was cast by the former Bank of Tokyo Mitsubishi Vice-President Nakahara Shin.

When this monetary policy management discussion began on the second day of the meeting, several members of the Policy Board judged that the terms of the "promise" regarding the easy monetary policy had been fulfilled, expressing that it would be best to end the policy and switch to an interest-rate policy. A Policy Board member, believed to be Nakahara, expressed the contrary opinion that (1) a little more time should be taken for an analysis to ensure that the rising trend in the CPI has been established, and (2) ending the quantitative easing policy at the end of the fiscal year would entail a degree of risk to the stability of the market. "Therefore, if possible, we should wait until the April Outlook Report to end it, or at the earliest at our first meeting in April." However, other members argued that, "The quantitative easing policy is an extraordinary measure that carries the risk of losing flexibility as a monetary policy and lowering market function. Therefore, since the conditions of the 'promise' have been satisfied, Photo: Kyodo News

we should replace it with an instrumental target policy quickly." Opinion swung toward ending the policy.

On the other hand, there were no requests to postpone ending the easy monetary policy from the government representatives in attendance. Vice Minister of Finance Akaba Kazuyoshi advanced as conditions for acceptance the continuation of zero interest, the clarification of a watchful stance toward interest rates as a whole, including long-term rates, and the continued purchase of long-term government bonds at current levels. He said in addition, "We understand that the BOJ is in agreement with these points," and "I want to pay due respect to the judgment of the Monetary Policy Meeting." Vice-Minister for Policy Coordination Nakajo Yoshiro said, "A comprehensive look at underlying trends in prices shows that there is still some deflation." Over and above emphasizing the government's goal of breaking out of deflation in FY 2006, however, he limited his remarks to urging "the continued cooperation of the government and the BOJ in the joint efforts to end deflation."

With the easy monetary policy ended, the market is now focused on the timing of the end of the zero interest-rate policy. The Outlook for Economic Activity and Prices, released by the BOJ after the April 28 Policy Meeting, forecasts that in FY 2006 through FY 2007 the Japanese economy will see "sustained and balanced expansion of domestic and overseas demand, in the corporate and household sectors." However, we are now in the 4th year of the economic recovery, and it is highly possible that from now on the economy will enter a stage of maturity, with growth rates "at the mid-2% level in FY 2006, the 2% level in FY 2007, trending toward the level of the potential growth rate and gradually slowing down." The median forecasts (5th forecast) for real gross domestic product (GDP) growth in FY 2006-2007 among the nine members of the Policy Board are 2.4% and 2.0%, respectively.

Looking at price forecasts: (1) the macro supply-demand gap is in the vicinity of zero, and there is a trend toward some excess demand in the future; and (2) it is highly possible that unit labor cost (labor cost per unity of manufacturing) will stop its fall and turn slightly upward. Also, the annual increase in consumer prices is expected to grow from around 0.5% in FY 2006 to almost 1% in FY 2007. The median forecasts for consumer price growth in FY 2006 and FY 2007 among the nine members of the Policy Board are 0.6% and 0.8%, respectively.

The outlook also mentions monetary policy management risks that should be carefully watched. "The condition of prices has turned around and improved from before, and this may have an encouraging effect on monetary policy." "Looking at the medium and long term, economic activity will increase significantly, and we must therefore be aware of the risk of significant changes in the inflation rate" if zero interest persists over the long term.

Subsequently, in the May edition of the BOJ's Monthly Report of Recent Economic and Financial Developments, published after the May 19 Monetary Policy Meeting, their evaluation of the outlook for business conditions was changed from the previous "the recovery will continue steadily," to "the economy will show mild expansion." This is the first use of the word "expansion" in an economic assessment since the Monthly Report of January 1998. However, at a press conference the same day, BOJ Governor Fukui repeated that he had no opinion with regard to the timing of the termination of zero interest.

In the market, forecasts for the timing of the end of zero interest are clustered around the period of July through September. One reason is that the reduction of the funding of the outstanding balance of current-account deposits is expected to be almost complete by June. In addition, Prime Minister Koizumi Junichiro has announced that he will resign at the end of his term as head of the LDP in September, and the government will be compiling its Basic Policies for Economic and Fiscal Management and Structural Reform at the end of June. If these policies include a resolution of the deflation problem, one can expect an end to zero interest. Reflecting these observations, in the bond market, interest on medium and long-term bonds, which is easily affected by policy rate changes, is rising.

However, given the precipitous increase in crude oil prices and the rise in the value of the yen, the early end to zero interest runs a risk of adverse effects on business conditions, a hurdle that must be cleared. In addition, in August 2000 the government's request for an extension was refused, and the end of zero interest was strongly pursued. Subsequently, however, the IT bubble burst and it was necessary to continue zero interest for half a year in an attempt to bolster business conditions. The necessity for implementing the anomalous quantitative easing was a traumatic experience for the BOJ, and some think the decision to end zero interest will have a subtle influence.*

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*Note : The article is based on the information available as of June 1.