Bank of Japan Meandering on Zero Interest Rate Policy

By Sakamoto Sakae

The Bank of Japan (BOJ) has guided short-term interest rates towards 0% under its zero interest rate policy without exception since February 1999, and between the end of September and the middle of October, it further reinforced its easy monetary stance to some extent. This was because of increasing demands from both within Japan and abroad for further relaxation against the backdrop of the rapid appreciation of the yen beginning in July. However, the Bank's recent revision of its monetary stance was done with reluctance as it did not arise from its own judgement. In addition, its explanations have been extremely difficult for people in other countries to understand.

Up till July, the dollar-yen exchange rate had moved in the middle of the ¥120 - ¥130 level but from August to September, the yen strengthened abruptly to the ¥100 - ¥105 range. The yen had thus appreciated by 15% in two months. Concerned that the recovering economy would sink back into recession on account of a drop in exports due to the strong yen, both political and business circles urged the Japanese monetary authorities to take steps to curb the yen's strength. Though the methods available for achieving this include further fiscal expansion, dollar buying intervention and further monetary easing, what was requested of the BOJ was further monetary easing in quantitative terms.

However, the BOJ had less of a feeling of crisis concerning the strong yen than did the Ministry of Finance (MOF), and even warned of the negative side of further monetary relaxation. And, at the Monetary Policy Meeting on September 21, in effect, the BOJ refused to institute quantitative monetary easing as advocated by the MOF, political leaders and the U.S. Department of the Treasury. According to informed sources, some opinions within the BOJ were that "a certain amount of yen appreciation was natural given increasing purchases of Japanese stocks by foreign investors in anticipation of a recovery in the Japanese economy" and that "remembering the mistaken policy of the late 1980s (making low interest rates long-term, which caused the economic bubble), it would be dangerous to further relax monetary control at time like this when the economic recovery is still fragile."

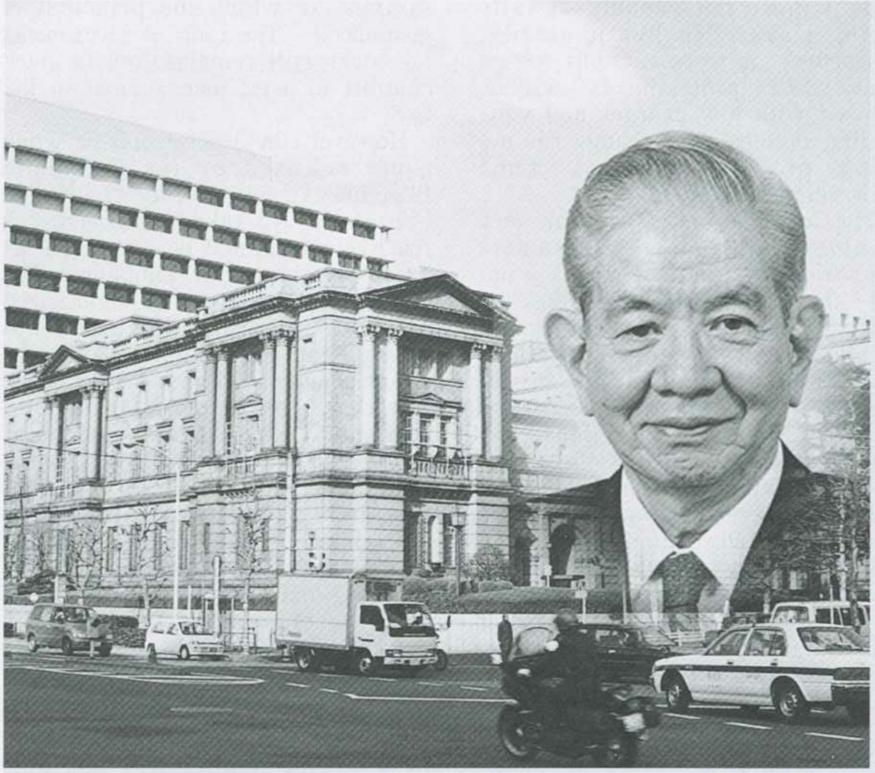

Photo:The Bank of Japan

Bank of Japan Governor Hayami Masaru

Statement of September 21

The statement issued following the Bank's Monetary Policy Meeting on September 21 in effect said "No" to the demands for further monetary easing from the Japanese Government, the Diet and the U.S. Government. The statement said that the BOJ had decided to continue to follow its extremely easy monetary policy - the "zero interest rate policy" - emphasizing the continuity of this policy.

The sentence in the statement "Since the launch of the zero interest rate policy in February, the Bank has continued to provide the financial market with ample funds to guide the overnight call rate as low as possible, currently at virtually zero percent" could be taken as meaning that there was no need for further policy measures because quantitative monetary easing had already been achieved under the zero interest rate policy and as criticizing the proponents of further monetary easing for their ignorance.

The statement also mentioned the relationship between monetary policy and exchange rates as follows: "The foreign exchange rate in itself is not a direct objective of monetary policy. One of the precious lessons we learned from the experience of policy operations during the bubble period is that monetary policy operations linked with control of the foreign exchange rate run the risk of leading to erroneous policy decisions," thereby refusing to formulate policy for the purpose of exchange rates.

At a press conference, the BOJ Governor, Hayami Masaru, reiterated this stance, making the following points: (1) Following the Louvre Accord in 1987, the BOJ lowered the Official Discount Rate to 2.5%, (2) Thereafter, as the economy then showed a rising trend, interest rates should have been raised early on, (3) Owing to pressure from business and political circles due to the strong yen, the raising of interest rates was postponed until February 1989, (4) If interest rates had been raised a little earlier, the bubble would have been contained a bit sooner and (5) From this, the BOJ had learned that monetary policy only in consideration of exchange rates is erroneous.

Statement of September 25

This statement disappointed the market, which had been expecting a further easing, and the BOJ came under attacks from the MOF, the Diet and the U.S. Department of the Treasury. Although details are not known as to what was discussed at the Group of Seven (G-7) meeting of finance ministers and central bank governors held in Washington on September 25, the BOJ effectively went back on its "No" to a further easing.

In his statement following the G-7 meeting, Mr.Hayami stressed the fact that "the Bank of Japan has provided ample liquidity in the context of the zero interest rate policy", emphasizing that it was essentially conducting quantitative easing. The statement also confirmed the fact that both the BOJ and the MOF were worried about the strong yen, saying that "The Bank is concerned about the negative impact of the recent rapid yen appreciation on economic activity and prices. This view is shared with the government." This is a virtual revision of the statement issued on September 21.

However, concerned about saving face (consistency in policy), the statement said, "The Bank is prepared to use the flexibility it has in the context of the present monetary policy stance to respond appropriately and timely to developments in the economy as well as financial markets, including the foreign exchange market." The BOJ was presumably saying that despite some amendments, there was fundamentally no change to the basis of its zero interest rate monetary policy.

At a press conference after the G-7 meeting, Mr.Hayami mentioned that "Our statement of September 21 was something of an academic paper in which we set forth our ideas. As there were many persons of advanced age at the G-7 meeting, like myself, the statement of September 25 used softer language. However, its content represents no change from our statement of September 21."

Such a justification made it more difficult to understand the statement of September 25, causing confusion among the media as well as market participants. In just four days the BOJ revised its policy stance (said in a different way, it had not been able to correctly interpret the prevailing political and economic conditions on September 21) and was insisting that there had been no change. This type of monetary policy and back-tracking in its explanation to outsiders reduced public confidence in the Bank of Japan.

Statement of October 13

It can be said that the statement of September 25 included concessions whose purpose was to raise concern at the G-7 meeting about the strength of the yen. In response, the G-7 statement said "We shared Japan's concern about the potential impact of the yen's appreciation for the Japanese economy and the world economy. We welcomed indications by the Japanese authorities that policies would be conducted appropriately in view of this potential impact." The BOJ gave up the inclusion of "the supply of ample funds" in the statement in lieu of "we shared Japan's concern," which hinted at the possibility of concerted market intervention.

At a Monetary Policy Meeting on October 13, the pledge made by the BOJ at the G-7 meeting to enhance money market operations was carried through concerning two points as follows: "With respect to operations using short-term government securities (TBs, FBs), in addition to current sales and purchases with repurchase / resale agreements (conditional trading), the Bank will introduce outright sales and purchases (unconditional trading)" and "To strengthen the capacity of fund provision, the Bank will add 2-year government securities for repo operations effective from today."

During September, the MOF and the Diet had planned to have the BOJ underwrite long-term government securities. The Bank flatly refused to do this, due to its opinion that underwriting government securities would cause irresponsible fiscal policy which could produce a hotbed of inflation. The BOJ's decision to introduce outright operations could be seen as a minimal response to this demand. JJTI

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