

Bank of Japan Lifts Zero Interest Rate Policy Despite Adverse Circumstances

By Tani Sadafumi

At the Bank of Japan's Monetary Policy Meeting on August 11, a majority voted to end the zero interest rate policy, which lasted for 18 months. This was the first move to tighten credit since August 1990, when the BOJ raised the official discount rate by 0.75 percentage points, to 6% per annum. As a result, the bank was able to encourage the uncollateralized overnight call rate to move on average at around 0.25%, instead of zero. But the official discount rate was kept intact at 0.5% per annum.

While the BOJ Governor Hayami Masaru was determined to lift the zero rate policy, strong objections were raised by Cabinet members, including Prime Minister Mori Yoshiro and Finance Minister Miyazawa Kiichi, as well as the Chairman of the Liberal Democratic Party's Policy Research Council, Kamei Shizuka. During the meeting on the 11th, observer members representing the government submitted a motion to request a delay in voting, which is allowed under the Bank of Japan Law. The outcome was a peculiar one. The bank's Policy Board voted against the request, then voted to lift the zero rate policy.

In relation to the change in monetary policy, the BOJ announced the following assessment of the economy. "Japan's economy has substantially improved, due to such factors as support from macroeconomic policy, recovery of the world economy, diminishing concerns over the financial system, and technological innovation in the broad information and communications arena. At present, Japan's economy is showing clearer signs of recovery, and this gradual upturn, led mainly by business fixed investment, is likely to continue. Under the circumstances, the downward pressure on prices stemming from weak demand has markedly receded." The bank then stated its



The BOJ Governor Hayami Masaru at a press conference after the meeting on August 11

Photo: Kyodo News

decision as follows. "Considering these developments, the Bank of Japan feels confident that Japan's economy has reached the state where deflationary concern has been dispelled, the condition for lifting the zero interest rate policy."

At the same time, the bank positioned the latest interest rate hike as "a small adjustment to the degree of monetary easing," and emphasized its intention to "conduct monetary policy in an appropriate and flexible manner to support the economic recovery." This reflected the BOJ's desire to dispel the view that its action was a move toward a tighter monetary policy, in order to prevent long-term interest rates from rising.

Originally, the zero interest rate policy adopted in February 1999 was "an emergency policy measure" (Governor Hayami) taken amidst extraordinary concerns at that time. It was aimed at stopping the soaring long-term interest rates that resulted from the government's stimulus budget appropriation for fiscal 2000 (from April 2000 to March 2001), requiring a massive issuance of government bonds. The BOJ did not want to protract this policy

and had been looking for a chance to terminate it. But the recovery of Japan's economy was slow in coming, and the bank had no other choice but to be extremely cautious about terminating support of the economy from the monetary side.

The bank wanted to lift the policy because of the possible negative effects on the economy in the event that the "abnormal interest rate in an emergency" (Governor Hayami) was allowed to continue over a long period. The bank supplied ample funds through its daily open market operations to guide the overnight call rate to 0.02%, which becomes nil after deducting the commissions of money market brokers. But the ample funds supplied did not necessarily translate into real economic

activities. They either piled up in excess in the BOJ reserve accounts or accumulated at the money market brokerages.

In contrast, the interest earned by putting one-million yen in a bank time deposit plunged to 1,200 yen per year (960 yen after tax). For a long time, Japan's household sector saved in excess, and both the corporate and the public sectors invested excessively. In other words, lower interest rates resulted in the transfer of income from ordinary households to companies and the government. Some households enjoyed the benefit of diminished housing loan payments. But in macroeconomic terms, the policy of zero interest asked the household sector to bear the burden.

Moreover, this policy enabled banks to procure funds at zero interest (zero cost) from the market. Because their burden from bad loans was alleviated, these banks were able to respond to demands by general construction companies and retailers to cut interest rates on their debts. As a result, companies which would otherwise have been weeded out survived, suggesting that the effect of the zero interest policy

Changes in monetary policy

1993	February	3.25%	→	2.5%
	September	2.5%	→	1.75%
1995	April	1.75%	→	1.0%
	September	1.0%	→	0.5%
1998	September	0.5%	→	0.25%
1999	February	0.20%	→	0%
2000	August	0%	→	0.25%

Note: Figures represent the official discount rate until September 1995, and thereafter the guidance target for the uncollateralized overnight call rate.

The BOJ has been emphasizing how important it is for the bank "to communicate with the market." Despite that, the market, which is made up of experts, interpreted the bank's intention in exactly the opposite way. This is why Governor Hayami had to make an extra effort for five days to get the policy back on the original track in his explanation before parliament.

First, he said he thought that there was "the prospect of the dispelling of deflationary concerns," qualifying the remark as his personal opinion. The comment deviated from the prepared text, which read, "nearing a stage in which there is the prospect of dispelling" and also took the bank's staff by surprise. But the market did not react to it.

So, Governor Hayami further escalated his remarks, saying that the "timing (of lifting the policy) needs to be quick" and that he did not think the Sogo issue significantly changed the environment surrounding the stock market. This naturally led to further intensification of the feelings of agitation towards the BOJ by the government and the Liberal Democratic Party. Finance Minister Miyazawa, in particular, took issue with having a BOJ governor give a personal view of the economy and expressing indifference towards the stock market. He reportedly expressed his displeasure to his aides.

The conflict between the BOJ and the government was therefore carried over to the Monetary Policy Meeting on August 11th. In accordance with Article 19 of the Bank of Japan Law, the two observers representing the government at the meeting requested a postponement of the vote on Governor Hayami's proposal to lift the zero interest rate policy. The nine members of the Policy Board, including the governor and two deputies, voted down this request by eight to one, then voted by seven to two to lift the policy.

was to stall structural reforms.

Another factor behind the decision was the determination by the Bank of Japan not to repeat its mistake of the mid-1980s. At that time, the BOJ kept the official discount rate at an all-time low of 2.5% for a long time to boost the economic recovery and to halt the appreciation of the yen. That this was indeed one of the factors that inflated the speculative bubble was a bitter lesson well remembered by the bank's young employees, who have now become managers.

Initially, the BOJ intended to terminate the zero rate policy at the July 17th meeting. But major department store operator Sogo failed immediately before the meeting. The bank therefore delayed its proposal "in order to monitor the possible impact of the collapse of Sogo." At that time, the bank did not believe the Sogo issue would have a negative impact on the overall economy. It is said that the BOJ was resolved to end the zero rate policy in August, barring some unexpected event.

Among the developments that followed, one BOJ miscalculation was the sluggish Tokyo stock market, with the index falling below the 16,000 yen level. The government began to believe there was a tacit understanding that support for the economy from the monetary side would continue. The financial circles also thought that the zero rate policy would not be lifted unless the stock index recovered the 17,000 yen level. And because the BOJ had traditionally been susceptible to government pressures, the prevailing view in the market was that the BOJ would listen to the government.

In addition, the Bank of Japan itself made a painful mistake. Exactly one week before the monetary policy meeting, Deputy Governor Yamaguchi Yutaka referred to the Sogo issue in a speech, saying that "naturally there is a need to consider whether there are risks that may add momentum to the anxiety in the market." The market took this as a signal that the lifting of the policy would be postponed. Deputy Governor Yamaguchi made the comment apparently on the belief that a central banker must sometimes make remarks that do not support the bank's policy. But it backfired.

The Bank of Japan Law stipulates that "the Bank of Japan shall always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control and the basic stance of the government's economic policy shall be mutually harmonious (Article 4)." It also allows the government to "request that the Board postpone a vote on monetary control matters until the next meeting of this type (Article 19-2)."

The government concluded that, because of the priority on economic recovery, the zero interest rate policy should not be lifted, and used its right to request a postponement of the vote. Senior State Secretary for Finance Murata Yoshitaka, who attended the meeting on behalf of vacationing Finance Minister Miyazawa, explained that the action was taken to secure transparency of the discussions.

In the process of drafting the current Bank of Japan Law that took effect in 1998, there were opinions that called for the removal of Article 19 to ensure the independence of the central bank. But the Ministry of Finance successfully overcame that view with the assurance that "in reality it is unlikely that the article will be invoked." Article 19 can be regarded as a symbol of government control over the Bank of Japan. The resort to the "family heirloom sword," which is superb but rarely used, suggests that the rift between the BOJ and the government was quite deep.

By not giving in to government pressures, the bank maintained its independence. But given that the BOJ misguided the market, it is questionable whether, in return for that independence, it met the conditions of accountability.

It is also undeniable that the discord between the central bank and the government represented not differences in policy views, but differences in emotion. JTI

Tani Sadafumi is an Editor in the Economic Division of Jiji Press Co., Ltd. His work focuses on the Bank of Japan and the Ministry of Finance. At the Washington branch of Jiji Press, he specialized in matters of trade and industry.