Deflation and Worsening Economy Pushed Bank of Japan to Cut Interest Rates Again

By Tani Sadafumi

At the Monetary Policy Meeting on Feb. 9, the Bank of Japan drew up a package of policy measures centering on reducing the official discount rate (ODR) to 0.35%, 0.15% lower than the previous rate of 0.5%. In August 2000, resisting fierce opposition from the Government and ruling party, the nation's central bank ended its zero-interest-rate policy, but now, after six months have passed, it has again lowered interest rates. Then, on Feb. 28, the Bank of Japan decided to reduce both the ODR and the target for the short-term interest rate by 0.1%. As a result, the ODR is now 0.25% and the target for the uncollateralized overnight call rate 0.15%. By doing this, the Bank showed its willingness to support the Japanese economy from a monetary standpoint, since it is showing a definite slowdown amid increasing signs of deflation and falls in share prices both in Japan and the U.S. markets due to slowing growth in the United States and other countries. In the process leading up to this move, the Bank of Japan was under a lot of political pressure from members of the Liberal Democratic Party (LDP) and other parties.

The Bank of Japan's initial package of monetary policy measures consisted of;

1) Reduction in the ODR (in February),
2) Introduction of a Lombard-type lending facility (in March),
3) Increase in outright operations of short-term government securities (in February), and
4) Preparation for the introduction of Bill Purchasing Operations at all business offices (in July).

The target for the uncollateralized overnight call rate (policy rate), however, remained at 0.25%.

The adjustment of the ODR is the first in five years and five months. The last adjustment was made in September 1995 from 1.0% to 0.5%. Since interest rates were completely liberalized in 1993, the core of the Bank of Japan's monetary policy has been controlling interest rates in the short-term money markets on a daily basis. This has been the sole monetary policy measure that the Bank has followed since the ODR was reduced to 0.5%.

The view held by the markets of the ODR was that it reduced its importance into merely signaling a major policy direction and that it was not something to be used in a piecemeal fashion. The common view of money market players was that 0.5% was already an ultra-low level and there was no room to reduce it further. Thus the Bank's decision came as a "great surprise" to the markets, according to a city bank official. The Bank of Japan's aim was for the announcement to have a surprise effect and in this sense, we could say that the Bank lowering the ODR has achieved the desired objective.

However, the other three provisions in the package will have more direct significance for the money markets. In particular, the Lombard-type lending facility is expected to be effective in stabilizing the short-term money markets. The Lombard lending facility is well known through its former use by the Deutsche Bundesbank, and the European Central Bank (ECB) is currently continuing it in the form of the Marginal Lending Facility (MLF).

At times when there is a temporary need for funds, such as at the end of the fiscal year, short-term interest rates may soar as the demand for funds swells. However, with the creation of the Lombard-type facility, financial institutions will be assured of being able to procure funds at low interest rates within the limits of their collateral, if they closely follow the Bank of Japan. This will result in greatly allaying the concerns of financial institutions, particularly small and medium-sized firms with low credit raising capabilities. However, it might also pose a moral hazard for the borrowing financial institutions. When banks cannot raise sufficient funds in the markets through their own efforts, "they will feel secure in the knowledge that the Bank of Japan will come to the rescue," the Bank of Japan Governor Hayami Masaru said.

The Bank of Japan will apply the ODR as the Lombard lending rate and thus, institutions will be able to borrow from the Bank at a rate of just 0.1% more than the short-term interest rate target. Considering that this rate is 1% lower than that of the ECB's MLF, there is a high risk of a moral hazard being created in Japan. For this reason, the Bank of Japan has made the period of the loan five days in principle and will apply a penalty rate of 2% above the ODR from the sixth day onwards.

Now let us briefly explain the remaining two measures. Increase in outright operations of short-term government securities is a mechanism by which the Bank of Japan will buy short-term government securities – including treasury bills (TBs) – having a remaining period of three months to one year on the market. The Bank created the system when dealing with the Millennium Bug last year but ceased using it after April 2000. However, the Bank of Japan has now announced that it will be used again with the objective of guiding the interest rates of relatively long-term securities (term securities) downwards. Under the last measure, the preparation for the introduction of Bill Purchasing Operations at all business offices, the Bank of Japan will purchase the bills of regional financial institutions temporarily experiencing shortages of funds in hand in order to stabilize their cash flow. Such institutions include regional banks, secondary regional banks, credit associations and credit unions.

It was not easy for the Bank of Japan to decide on these measures. It involved two factors: 1) signs of a decline in Japanese exports with a slowdown in the United States and other economies and 2) the slump in Japanese and U.S. share prices. However, on the other hand, Hayami reaffirmed his basic stance that the "economy continued to follow a gentle recovery track" and that "there had been no change in basic monetary policy."

However, while Japan's real GDP growth for the July-September quarter of 2000 had initially been reported as a 0.2% increase from the previous period (annual growth rate of 1.0%), in the second report it was revised downwards greatly to -0.6% (-2.4% for the year). Further, the consumer price index for 2000 dipped by a total of 0.7% compared with the previous year, and if perishable foods are excluded, the index drops by 0.4%, a tremendous decline from a year ago. These statistics, at least, show that there was already a slowdown in the economy coupled with deflation at the time the Bank of Japan acted to end the zero-interest-rate policy.

In spite of this, Hayami has been promoting the idea that this is a "good fall in prices," saying that behind the falling of prices is not the demand side factor of stagnating consumption but the supply side factor of distribution structures becoming more streamlined. Further, though he recognizes the need to provide monetary support for the economy, Hayami wants to avoid quantitative easing commenting that, "Since the economy is on a gentle recovery track there is no call to adopt drastic measures." On the reintroduction of the zero-interest-rate policy he expressed his opposition saying, "It won't be reintroduced unless there is a serious risk of falling into a deflationary spiral."

The policy decisions made on Feb. 9 were made on the basis of this fundamental view of the economy. Though the Bank of Japan is not admitting to failure in rescinding the zero-interest-rate policy, it is installing a "safety valve" in the short-term money markets to ensure that the economy does not falter in view of its more gloomy prospects. It must also respond to the demands of the politicians to a certain extent. The package of measures centering on the ODR reduction was drawn up as the solution to this complex equation. Though it may look a bit thin on substance, it was likely to be readily accepted by people. The Bank of Japan surely went to great pains in preparing it.

On the day the policy decisions were announced, they were welcomed by the LDP's executive but they soon turned to criticism when it became apparent that it had done nothing to lift stock prices. Since then, many opinions have been actively expressed on the matter. Some are demanding that the Bank of Japan Law, which asserts the Bank's independence, be revised to allow intervention by politicians and others urge Hayami's replacement. This shows just how many politicians felt bitter about the ending of the zero-interest-rate policy last summer.

Around two weeks after the Bank of Japan announced its policy measures, the meeting of the finance ministers and central bank chiefs from the Group of Seven was held in Palermo, Italy. At the meeting, the state of the U.S. and Japanese economies was focused on as an issue of concern for the global economy. U.S. Treasury Secretary Paul O'Neill represented President Bush's new administration. Unlike his predecessor Lawrence Summers, O'Neill didn't openly make demands on Japan. The G7 joint declaration pointed out that there was a continuing need for Japan to use monetary policy to ensure ample liquidity, adding to concern about Japan's deflationary trend. In press conferences with journalists from each individual country, Hayami said no demands were made for new monetary policies but he had a tortured expression throughout. In contrast, since fiscal policies were not mentioned in the declaration, Japanese Finance Minister Miyazawa Kiichi, who was sitting beside him, beamed when he replied to journalists' questions.

Put in a corner in this way, the Bank of Japan has now started to change direction. In an interview with some of the media in late February, the Deputy Governor of the Bank of Japan Yamaguchi Yutaka, who is seen as a de facto chief in the Bank of Japan secretariat as regards monetary policy, strongly hinted that there would be further monetary easing saying, "We will choose the best policies available to us. We have a number of options."

Thus, the Bank of Japan acted to reduce the ODR and lower its target for short-term interest rates at its Policy Board meeting on Feb. 29, giving the worsening state of the economy and concerns about deflation as its reasons. Regarding the latter, which will actually have the major effect, the Bank of Japan has effectively made a policy change in the sense that it seems to have abandoned the assertion made at the last Policy Board meeting on Feb. 9 that the zero-interest-rate policy would not be reintroduced. At a press conference on Feb. 29, Hayami said, "We have to be very careful about the consequences and ripple effects of unusual policies like the zero-interest-rate policy," and "at the present time I cannot comment on whether we will increase our buying of long-term government securities because this has to be done in consideration of the future course of events." He thus seemed more receptive toward zero interest rates and quantitative easing than he had ever seemed.

If signs again emerge that the economic recovery is faltering, there will inevitably be greater pressure on the Bank of Japan both from within Japan and from outside. Many economists foresee that Hayami will be pushed into a situation where he has to adopt "escape measures" such as the zero-interest-rate policy or "drastic measures" such as quantitative easing. JJTI

Note: On March 19, noting increasing deflationary pressures, the Bank of Japan embarked on a quantitative easing policy under which the balance of financial institutions' current deposits with the Bank of Japan has been increased from ¥4 to ¥5 trillion. This policy will be continued until consumer prices stop falling. Since the target of monetary adjustment has been shifted from interest rates to a quantity of money, this is not a return to the zero interest rate policy in the strict sense. However as Hayami has explained, "Its result will be to keep short-term interest rates close to zero," so we could say that it is a de facto revival of "zero interest rates."

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