

BOJ to End Quantitative Easing Policy in the First Half of 2006

By Aoki Masaru

THERE is an increasing possibility that the Bank of Japan (BOJ)'s so-called quantitative easing policy, introduced in March 2001, will be rescinded in the first half of 2006. The reason is that the stated precondition for rescission – the year-on-year growth rate in the nation's core consumer price index (CPI), which excludes fresh foods, is 0% or higher on a sustained basis – is increasingly likely to be achieved.

The BOJ introduced the quantitative easing policy as an exceptional measure to combat deflation at the Monetary Policy Meeting in March 19, 2001, when Hayami Masaru was the BOJ Governor. The main objective of monetary policy had changed from overnight call rate levels to the balance of financial institutions' current accounts at the BOJ. At the same time, it was decided that the BOJ would increase its outright purchases of long-term government bonds as necessary from the then-current level of ¥400 billion per month.

Seven months earlier, at the Monetary Policy Meeting on Aug. 9, 2000, the BOJ decided to raise its overnight call target rate to around 0.25% on the grounds that "deflationary concerns could be eliminated." The decision replaced the "zero-interest-rate policy" put into effect in February 1999, which had targeted the overnight call rate close to 0%. However, because of the sudden economic downturn in the United States in the wake of the Internet bubble and the worldwide stock market plunge, concerns over Japanese economic slowdown surfaced and deflationary pressures increased. At its Monetary Policy Meeting on Feb. 9, 2001, the BOJ decided to lower the official discount rate to 0.35% as of Feb. 13, and returned to an easy monetary policy. The BOJ also decided to introduce a Lombard-type lending facility through which, when short-term market interest rates increase rapidly, the BOJ provides funds at the

official discount rate to financial institutions.

At the Monetary Policy Meeting on Feb. 28, the BOJ cut the overnight call target rate by 0.10 points to 0.15% annually, and lowered the official discount rate, also by 0.10 points, to 0.25% annually, both rates effective March 1. In the Ministerial Council on Monthly Economic Report on March 16, Aso Taro, then Minister of State for Economic and Fiscal Policy, officially recognized the first deflation in postwar Japan: "If you define deflation as a continuous price decline, the Japanese economy currently is under moderate deflation." Three days later, the BOJ decided to institute a quantitative easing policy for the first time in its history, and effectively revived the zero-interest-rate policy by supplying funds exceeding the official deposit reserve.

At the time, the balance of the BOJ's current accounts was targeted at approximately ¥5 trillion, ¥1 trillion above the official deposit reserve. During the term of Governor Hayami, it was increased three times in 2001 and once in 2002, ending up at a level of ¥15-20 trillion. After Fukui Toshihiko became the Governor in March 2003, it was increased again to the "¥27-32 trillion level" in October 2003, and "¥30-35 trillion" as of January 2004. To match this enhanced quantitative easing policy, the outright purchase of long-term government bonds was increased and reached ¥1.2 trillion per month after November 2002.

Under the quantitative easing policy, the Japanese economy, which had been in a recession since November 2000, bottomed in January 2002 and began to grow. From the last half of 2004 the economic recovery stalled temporarily, triggered by a production and inventory adjustment in IT-related industries, however, both the government and BOJ declared an end to the pause in August,



The BOJ Governor, Fukui Toshihiko

2005.

The quantitative easing policy contributed to the stability of the financial system by making it easier for financial institutions to obtain funds. The banks' bad debt disposal is proceeding; all seven large banks had met the target of the government's financial revitalization program of reducing the percentage of bad-debts by half by the end of FY 2004. In April 2005, the so-called payoff scheme was implemented and the blanket guarantee on demand deposits was ended. Given these developments, the lack of confidence in Japan's financial system has been substantially ameliorated.

Against this backdrop of improving stability, BOJ Deputy Governor Iwata Kazumasa, who had once appeared to be in the cautious camp vis-à-vis the rescission of the quantitative easing policy, said in a speech in last August, "We have reached the stage when the time won't be long where conditions are ripe for the cancellation of the quantitative easing policy." Statements from the BOJ's policy board members in favor of an early cancellation of the quantitative easing policy have rapidly increased since last September.

At an informal meeting with members

of the Kansai financial community in Osaka in September, Fukui expressed his opinion on the timing of eliminating the quantitative easing policy as follows: "Toward FY 2006, the possibility of rescission gradually becomes stronger." Moreover, in speaking to the media after the meeting, he clarified that "FY 2006" can be read: "before entering FY 2006 (which begins in April 2006), or after some months into FY 2006," raising the possibility that rescission might come as early as sometime in FY 2005. Among the nine-member policy board that includes the governor, two deputy governors and six other members, a cautious stance toward rescission has only been expressed by Nakahara Shin, former Deputy President of the Bank of Tokyo-Mitsubishi, who in a speech in October said, "The gap between supply and demand hasn't closed that much, and it is still difficult for prices to rise in this environment."

Upon the introduction, the BOJ announced that the quantitative easing policy would continue until the core CPI registers 0% or more year-on-year growth on a sustained basis. In October 2003, to increase the transparency of financial policy, the BOJ set forth three concrete conditions for the rescission of the policy: (1) the core CPI growth rate year-on-year must be 0% or above for at least a few months; (2) many members of the BOJ's Policy Board must be of the opinion that the year-on-year core CPI growth will continue to be 0% or higher in the future; and (3) these determinations must be decided together in the context of the overall economy and price levels.

In forecasting the BOJ's financial policies, market participants place special emphasis on its Outlook for Economic Activity and Prices (known as the "outlook report"), which is issued twice a year, in April and October. The report includes the forecasts of the nine policy board members for real GDP, the core CPI, and the domestic corporate goods price index.

In the October 2005 outlook report, the median forecast (i.e., the fifth high-

est estimate among the nine forecasts of policy board members) for FY 2005 called for a year-on-year growth in the core CPI of +0.1%, an upward revision from the -0.1% price change estimated in the April 2005 report, and the first forecast of a positive price change in eight years. It reflects the absence of falling prices for rice and electric/telephone service, which were on a downward slope for specific reasons. In addition, the estimate for an upward price change in FY 2006 was lifted to 0.5% from 0.3% in the previous outlook report and thus "a positive tone has been established for price change."

With respect to real GDP growth, the FY 2005 estimate was revised upward in the October report to 2.2% (1.3% in April), and the FY 2006 forecast was raised to 1.8% (1.6% in April). Regarding the cancellation of the quantitative easing policy, the April report said, "the possibility in FY 2006 is gradually becoming high," while the October report said, "the possibility in FY 2006 is becoming high," thus deleting the modifier, "gradually."

However, the cancellation could be postponed if the influence of skyrocketing oil prices and overseas business conditions, especially in the United States, cause revisions in economic and price expectations for Japan. An intermediate-term appraisal of the validity of the economic and price forecasts of the outlook report is scheduled for the Monetary Policy Meeting in January 2006.

The BOJ went ahead with the plan to lift its zero-interest-rate policy in August 2000, despite the government representative's opposition and request to postpone the decision until the next meeting in September. It is possible that the



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government, which is worrying about the impact of higher taxes on rebuilding the nation's finances, will oppose the removal of the quantitative easing policy because of concerns about the negative impact on the nation's economy. The BOJ will be pressed to make decisions cautiously.

Markets are very concerned not only with the timing of canceling the quantitative easing policy, but the method of rescission as well. The BOJ explained the change in the framework of current monetary policy in its outlook report, saying it "would mean a reduction in the outstanding balance of current accounts toward a level in line with required reserves, and a shift in the main operating target for money market operations from the outstanding balance of current accounts to short-term interest rates." With respect to the process for this switch, the report says, "After a period of extremely low interest rates, we will pursue a course of gradually adjusting the level of rates to correspond to the state of the economy and price levels," suggesting that, at least at first, the zero-interest-rate policy will continue. **JS**

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