

The Bank of Japan's Mistaken Choices

By Sakamoto Sakae

Strong yen: a turn of the century phenomenon?

Since the beginning of the year, a succession of events that, in the words of a risk management specialist, "could never happen here" have: the Kobe earthquake, discussed in the previous issue; the sarin gas terrorist attack, apparently carried out by a religious cult; the ultra-strong yen which has risen 25% this year; small financial institutions enveloped in political and governmental scandals; and the election of comedy stars in the Tokyo and Osaka gubernatorial elections.

At the end of every year, the Japanese media compiles the 10 top news stories, and I have the feeling that this year's top spots have occurred between the January to April period alone. As a result, influential media leaders are lamenting these "turn of the century

phenomena." Leaving aside the appearance of comedians as governors, what the Kobe earthquake, the sarin incident, the rapidly strengthening yen, and the financial scandals (including the murky involvement of the Ministry of Finance and the political world in the drama surrounding the bailout of two Tokyo credit unions) have in common is the lack of a response from the three-party Murayama coalition, composed of the Liberal Democratic Party, the Social Democratic Party of Japan and Sakigake. Many of the media refer to the government that cannot control these social and economic crises as an "administration without any measures."

According to one political analyst, "Unable to skillfully deal with these problems that have cropped up one after another, the coalition government is beginning to lose the people's confidence and it is only a matter of time

before the dissolution of the Murayama administration becomes one of this year's top 10 news stories."

The government and the Bank of Japan responded to one potential top story, the yen rate's abrupt rise (from ¥101 to the dollar at the beginning of January to around ¥79 in mid-April), with a package of economic measures and a reduction in the official discount rate on April 14, efforts that were largely ignored by the markets. In particular, the rate cut was not linked to the Bundesbank's discount rate reduction (implemented March 30), and criticism focused on the two-week delay.

Of course, the BOJ was not idle during that period. Provisional measures to induce lower money market rates (announced March 31) were implemented. The market's reaction, however, was sluggish. Why did the BOJ hesitate to fully coordinate with the Bundesbank on

a quick discount rate reduction? Has a change occurred in the practice of employing the discount rate as the primary fiscal policy tool?

Money market rates drop

The day following the Bundesbank's action in response to the weakening dollar and strengthening mark, the BOJ released a statement declaring inducement of lower money market rates. In part the statement read: "The economy continues along the road to recovery, but the pace is quite slow. From the standpoint of commodity prices, wholesale prices, mainly for final products, have shown a bearish tendency and the breadth of price increases for consumer goods compared to the pre-



There is talk that the BOJ spurred the yen's rise with missteps in fiscal policy.

vious year has also continued to trend downward. There has been an increasing level of general commodity price stability overall. From a financial perspective, the growth in the money supply has remained slow. Recently, the bond and securities markets have been affected by the recent upward tendency of the yen exchange rate, leading to a belief that the economy's future direction is increasingly unclear."

Based on this analysis of the economy, commodity prices, the money supply, and markets the BOJ noted, "With regard to interim financial controls, it is appropriate to encourage a lowering of short-term market rates consistent with the discount rate's current level (1.75% at that time) for the maximum benefits of financial deregulation." From the beginning through the middle of April, the BOJ supplied a tremendous amount of funds to financial markets, encouraging a drop in the short-term market rates, such as those on certificates of deposit and other negotiables. As a result, the short-term prime rate (set in accordance with market interest rates for CDs and other items) applied when companies borrow funds from banks also fell substantially.

If limited to just market rates, the BOJ achieved its goal. But the yen continued to climb, soaring to ¥79 to the dollar. One interpretation of these events from a market source follows: "Although the markets were expecting a cut in the discount rate (the effects of such an announcement would have been considerable), the BOJ tried to tame the rising yen by guiding market rates lower (believed to be a less effective policy than controlling the discount rate). The markets were disappointed by this misdirected BOJ policy decision, leading to the yen's additional rise."

One BOJ observer offers five reasons why the financial policy choices were in error. First, when the MOF released its interim fiscal and financial policy on March 27 in response to the yen's rise, it referred to the BOJ's jurisdiction—financial policy—with the expression, "Efforts will be made in the future to manage financial policies with agility and flexibility while carefully

heeding the internal and external economic situation," causing the BOJ to respond with the inducement of lower money market rates, a measure resulting in minimal change as of the end of March.

Second, because the Bundesbank's discount rate cut was unexpected, the BOJ had not anticipated a necessary discount rate response. Third, the BOJ dislikes manipulating the discount rate on behalf of exchange rates and opted for the most market-responsive measure. Fourth, now that interest rate liberalization is proceeding, an increasing number of people within the BOJ have been deemphasizing the significance of the discount rate and emphasizing market interest rates. The BOJ had determined that exchange market measures would ultimately be sufficient with the latter measure.

Finally, the BOJ failed to fully grasp that exchange dealers have not completely understood the advances in interest rate liberalization and changes in financial policies (the diminishing role of the discount rate) in Japan.

Political pressure from coalition parties

Naturally, the BOJ has not conceded that it was mistaken in its financial policy choices. However, it can be interpreted that the decision to lower the discount rate two weeks after the announcement of its intention of guiding market rates lower was in fact an admission of error. Parenthetically, the BOJ's reasons for the decision to lower the discount rate, contained in the April 14 statement, are noted below.

"The economy is continuing to recover slowly. However, with the further strengthening of the yen, continued weakening of property prices, and other environmental changes, there is anxiety regarding the economy's sustained recovery. The BOJ recently took steps to encourage reductions in short-term interest rates and various market rates have currently declined substantially. However, in line with subsequent environmental changes and as a result of a comprehensive review of the economic

and fiscal situation it was deemed appropriate at this time to build maximum support for economic activities from a financial standpoint by attempting to lower market rates further."

In this statement, the central bank cited "environmental changes" as the reason why the inducement of lower market rates proved insufficient and the official discount rate was necessary, stressing that bank's policy choices were not mistaken. Although it is natural for the BOJ to make such an assertion as it is an official statement, it is extremely unnatural that important policy decisions have been made twice in a mere two weeks.

A BOJ observer explains: "From early to mid-April the industrial sector, the MOF, and politicians exerted heavy pressure on the BOJ to lower the discount rate. In the end, the BOJ, which tried to maintain its independence by inducing lower money market rates, ended up having its autonomy violated by insisting on its own course."

On April 13, the day before the government announced its package of economic measures, the three governing parties compiled a "wish list" for the government. At the outset this policy petition notes, "In the midst of abrupt changes in the overall international currency situation, the yen rate has skyrocketed in the past several weeks, casting serious anxiety and doubt about the future direction of Japan's economy, both in the short- and mid-term." The section dealing with fiscal and monetary policies clearly requests additional interest rate reductions, stating, "It is to be hoped that the fiscal authorities implement appropriate and agile financial policies, paying careful attention to the internal and external economic situation." At the mercy of the markets and politics—including Finance Ministry pressure—the BOJ must reflect on the many aspects of the latest official discount rate cut, the eighth in the recent phase of financial deregulation.

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