

BOJ Poised to Raise Interest Rates

By Sakamoto Sakae

In the half year since the Bank of Japan (BOJ) lowered the official discount rate to a post-war low of 0.5% in September 1995 (in response to the skyrocketing yen and plummeting dollar rates and the extended recession), short-term interest rates, which are subject to market operations, have also remained at levels below 0.5%. However, at the beginning of the new fiscal year in April (the government and many companies use the April to March fiscal year) the BOJ temporarily abandoned efforts to drive short-term interest rates down, subtly altering market operations. A market source predicts, "Japan's economy has begun a gradual recovery process and is emerging from a terrible situation. The BOJ will probably soon drop the extremely easy money policy it has employed for the past half year and switch to a posture of clearly approving a rise in interest rates."

Every three months the BOJ *Quarterly Economic Outlook* is published, showing financial authorities' views on the economy. Reviewing the spring edition, released in mid-April, the employment situation, an indicator of a lag in the economy, was still seen to be an issue but, on the whole, the tone was comparatively optimistic. The BOJ has apparently begun setting the stage for a shift in its monetary policies.

In the bank's current view, with the effects of financial and fiscal policies implemented last spring and corrections to the strong yen that have now taken hold, corporate profits and confidence

have improved and consumer spending has also picked up. This is because, although net exports have continued to decline, domestic demand has continued to rise with broad increases in public works spending as well as growing investment in housing. Gradual capital expenditures and individual consumption have also steadily, if moderately, recovered. With the exception of some industries, inventories are generally at appropriate levels and mining and manufacturing production has also slowly increased since the end of last year. The BOJ notes, however, "although some indicators have begun to improve, the employment situation remains generally severe."

employment situation remains generally severe."

Economy gradually rebounding

Regarding the outlook for Japan's economy, the BOJ forecasts in its *Quarterly Economic Outlook* that public works outlays and housing investment, which have propelled the economy up to now, will slacken. Analyzing public works investments, the bank notes, "September 1995 economic policies were forecast to have an interim impact on production and employment, but the stimulative effects on the economy are expected to diminish in the latter half of the fiscal year (October 1996 to March 1997)." Further, regarding housing outlays, the bank predicts that demand will

remain sluggish, noting "there is a great likelihood that low interest rates will continue to yield high levels of investment in future, but if only because some sectors suffered a backlash slump following the previous rapid recovery at the beginning of 1995, the tempo of the increase is expected to steadily slow from here on."

However, in the BOJ's economic recovery scenario, upturns in capital expenditures and individual consumption will compensate for sluggish public works spending and housing outlays. Regarding facilities investments, the bank notes, "with additional profitability from corporate restructuring efforts, corrections to the strong yen, and increased sales and production, major corporations and manufacturers will maintain their recovery and, although somewhat delayed, non-manufacturing sectors and smaller companies will begin to rally, so an overall upturn is expected to gather strength." Further, on the subject of individual consumption, the bank predicts, "as the employment situation is expected to continue to improve, however slightly, there is a strong possibility that the climate for a recovery will incrementally build strength."

The BOJ summarizes the synthesis of these positive and negative factors by saying, "it is possible to predict that, through corporate and household income formation accompanying increases in overall domestic consumption and manufacturing, Japan's economy will shift in stages to a process of moderate autonomous recovery, led by capital expenditures and individual consumption." Regarding interim monetary policies, the bank states, "while stressing support for a solid foundation for an economic recovery led by private-sector demand, it will be appropriate to meticulously examine the development of the monetary and economic situation."

Portions of the monetary policy could be described as having been phrased



Bank of Japan Governor Matsushita faces an interview.

Photo: Kyodo News Service

extremely subtly. This is because "a solid foundation for an economic recovery" is a declaration of the decision to support previous easy money strategies, but "meticulously examine the development of the monetary and economic situation" indicates the possibility of a shift in monetary policy.

Market interest rates rise at end of February

The financial and bond markets have noticed the signs of a change in the BOJ's policy stance and both short- and long-term interest rates are rising. From September 1995 onward, certificates of deposit (CDs), one indicator of short-term interest rates, were around the level of the discount rate (around 0.5%) for three-month interest rates, but temporarily rose to 0.7% in late February following a succession of economic indicators that indicated a business upswing. Moreover, the yield on government bonds, an indicator of long-term interest rates, had been trending at around 3.0% until early February, but also climbed to 3.4% in the latter part of the month. Long and short-term rates subsequently declined slightly to a level approaching that of early February. However, in strong anticipation of future interest rate gains the markets are now reacting sensitively to financial authorities' subtle pronouncements (statements suggesting a lifting of easy money strategies).

BOJ statements indicating the creation of an environment for a shift in monetary policies have not been limited to the quarterly report. The BOJ's governor, Matsushita Yasuo, has also played a role in fomenting the market's anticipation of future rate increases. In an early April speech in Tokyo, Matsushita noted, "With increasing expectations of an economic rebound it is natural for interest rates to rise and as long as the extent conforms with a recovery in expected corporate profitability it should not be a direct limiting factor on corporate activity; rather, interest rates would rise as the economy recovers. This is considered part of an ordinary business recovery." Needless

to say, financial markets, in which there was growing anticipation of future interest rate increases, and especially the long-term interest rate market, reacted to this statement.

Some are of the opinion that, just because Matsushita said something that is written in any economics textbook, it does not particularly indicate that he was touching on monetary policy decisions. However, one cannot help speculating that he must clearly be up to something when he mentions the relationship between corporate profitability and interest rates at a point when the trend toward improved corporate profitability has become clear. Matsushita additionally assessed the way that interest rates function as indicators of the direction in which the economy is headed with the comments, "As the markets digest various types of information they are naturally seeking a point of stability that conforms with economic trends," and, "Interpreting the past few months' market trends, the slow rise of long-term interest rates from the end of last year reflects the reality of the steady economic upturn."

Curbing U.S. and Japanese rate rises

However, there is also strong opposition to the BOJ's strategy to move away from extremely low interest rates. There is a risk that rising Japanese interest rates might lead to a chain reaction of a strong yen-weak dollar, declining U.S. government bonds (and rising long-term interest rates), a collapsing U.S. stock market, and a downturn in the U.S. economy, an unacceptable scenario for U.S. President Bill Clinton, who is seeking reelection in the 1996 November presidential election. Prime Minister Hashimoto Ryutaro, who must battle a general election in July this year at the earliest (the first since the shift to the single-seat constituency system), also wants to avoid the risk of rising interest rates dashing water on the economy as it begins to show signs of a recovery. Moreover, the Finance Ministry, which has placed top priority on fiscal restructuring in the face of a

huge outstanding balance of deficit-covering bonds, also needs to have monetary policy (the maintenance of low interest rates) tied to economic policy for the time being.

In other words, the BOJ is being hemmed in by the Finance Ministry, which wants to avoid economic stimulation by fiscal measures and the current administrations in both Japan and the U.S. await upcoming elections. The BOJ has been using its quarterly report, the governor's speeches and other means in its efforts to seek a way of lifting extremely low interest rates because it is aware of how stiff the political and fiscal authorities' opposition is.

At the meeting of the G7 finance ministers and central bankers at the end of April and the International Monetary Fund provisional committee meeting that followed, the U.S. Treasury Department sent the BOJ a message that it wanted to see easy money policies continued. At a post-G7 meeting press conference, U.S. Treasury Secretary Robert Rubin remarked, "Japan must continue economic growth and domestic demand expansion," and, speaking at the Interim Committee meeting, noted that "There is a risk that early belt-tightening measures might damage the economic recovery." Just before the recent G7 meeting the IMF announced that Japan's 1996 GDP growth would be 2.7%, the highest of the G7 nations. This could also be considered a message that the BOJ should show restraint.

In spite of this, *Asahi Shimbun*, one of Japan's leading newspapers, reported at the end of April, "In one to two months the BOJ would probably raise the target rate for short-term interest rates by around 0.25% to 0.75% and might also boost the official discount rate (currently 0.5%)." This article speaks by proxy for the feelings (soul-searching) of BOJ staffers, whose errors in timing interest rate rises the last time the economy showed signs of a recovery, ended up generating the "bubble" economy. ■

Sakamoto Sakae is an economic news editor at Jiji Press news agency. He specializes in such fields as finance and international economic affairs.