
Quantitative Credit-Easing Policy at Turning Point

– Financial Stability Makes It Hard to Achieve Liquidity Target –

THE quantitative monetary-easing policy the Bank of Japan (BOJ) adopted in March 2001 with the prime aim of pulling the nation out of a deflationary spiral is now facing a turning point. Quantitative easing refers to the BOJ's policy tools such as continuing the funneling of massive liquidity into the capital and financial markets even after short-term interest rates fall below zero – a monetary policy that has never been implemented by any industrial nation except for Japan. Declining demand for funds from financial institutions in line with receding anxieties in the nation's financial system is making it hard for the BOJ to attain its liquidity target.

Usually, the stabilization of a nation's financial system provides its monetary authorities with a good opportunity to

return to an ordinary monetary policy, under which they raise or lower interest rates as a way to adjust the credit supply. As far as Japan is concerned, however, the situation is not so simple. Given persistent deflationary phenomena such as falls in consumer prices, the BOJ has repeatedly pledged to maintain a quantitative monetary-easing policy at meetings of finance ministers and central bankers from the G7 economic powers. The Japanese government is also reluctant to end the quantitative easing as it fears such action may lead to higher long-term interest rates. The BOJ is pondering how to supply funds to those financial institutions which are loath to receive any more funds.

If the current unusual situation is left unattended for years, the Japanese econo-

my will be increasingly distorted. The government continues to issue bonds, taking advantage of historically low long-term interest rates caused by a long period of quantitative easing – a move eroding fiscal discipline. The phenomenon of a money glut has already begun to show up in the economy, stirring worries about a possible moral hazard due to the continued injection of massive funds.

In its biannual economic outlook report published in April, the BOJ said the Japanese economy will extricate itself from deflation in FY 2006, when the nation's consumer price index is projected to rise 0.3% from the previous year. A major challenge facing the BOJ is how best to steer quantitative easing in line with that projection.