

ECOMENTARY™

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A Revolution in Japanese Monetary Policy: Where is the Quo for this Quid?

In our view, a striking change has actually occurred in Japan. The change is sufficiently important for the long run evolution of the Japanese economy that we take the liberty of actually publishing the documents that appeared on the BoJ website. Readers familiar with the usual opacity of Central Bank communications might note the clarity of the documents in English. That alone should tell us that the BoJ is trying to communicate a major change. It wants the change to be easily read by markets in Japan and around the world. That indicates to us that the BoJ wishes not only to change the policy but also expectations in the market.

The significant changes in our view are the following:

- A) There is now an explicit quantitative target. This is a huge break from the past although commentators in Japan seem determined to see this as a return to ZIRP. It is not that at all, even though interest rates may fall to approximate a Zirp condition. THE DIFFERENCE IS THAT IT LEAVES TO THE DISCRETION OF THE BANK HOW LARGE WILL BE THE INCREASE IN THEIR CHOSEN MONETARY AGGREGATE. THIS IS WHAT MANY MONETARY ECONOMISTS HAVE LONG ARGUED IS ESSENTIAL FOR JAPAN TO REGAIN ITS ECONOMIC HEALTH. NOTICE HOW THE AGGREGATE IS CHOSEN. IT IS AN AGGREGATE THAT THE BANK CAN CONTROL! NOTE ALSO THAT IT IS NOT THE 'MONETARY BASE,' BECAUSE THE BASE INCLUDES CURRENCY, THE DEMAND FOR WHICH THE BANK DOES NOT CONTROL. IT ONLY CONTROLS RESERVES.
- B) In taking control of this monetary aggregate, the BoJ has removed any ambiguity about Who is determining the quantity of reserves. Previously, the Lombard facility left quantity determination to be made by the Demand for Reserves. Control is now with the BoJ.
- C) If Reserves are now the Target (not interest rates), what will determine how large reserves will be? The BoJ has provided a proximate decision variable---the behavior of the CPI. This may or may not be the "best" proximate target, but critics of the BoJ in past years who have advocated strong measures against deflation should feel that they have made their point! The BoJ is telling the market clearly that it intends to end deflationary pressure as measured by the CPI.
- D) The BoJ has told markets that it regards the current Japanese economy in sufficient peril to "warrant monetary easing as drastic as is unlikely to be taken under ordinary circumstances." The BoJ could not have been more explicit for market observers. They are leaning hard against the wind of deflation and they have told the market for how long they will do this (the CPI condition).
- E) To remove any possible ambiguity, the BoJ has even set out in Q and A form how it will make the appropriate translation of its policy variable (the Reserves) into conventional HIGH POWERED MONEY. Remembering that the Currency makes up nearly all of the reserves (say 90% or more), the fulcrum for changing reserves is the incremental supply that the Current Account Balance of the BoJ puts into the market. But, for those who look at the Base or High Powered Money, Q3 and A3 below makes the translation totally clear.

WHERE'S THE QUO FOR THIS QUID?

Long time observers of the Japanese monetary politics should ask themselves one question. 'What has the Bank of Japan gotten back from the Government in exchange for adopting a strong quantitative commitment to ending deflation?' We don't know the answer that the Government has given. We only know the demand that the Bank of Japan has made.

"In order to make this monetary easing fully effective in restoring Japan's economy on a sustainable growth path, progress in structural reforms with respect to the financial system, e.g., resolution of the non-performing asset problem, as well as in the area of economy and industry is essential. Structural reform may be accompanied by painful adjustments. Without such adjustments, however, neither improvement in productivity nor sustainable economic growth can be obtained. The Bank of Japan strongly hopes that decisive actions be taken to address fundamental problems both with a clear support of the nation for structural reform and under a strong leadership of the government of Japan."

The Government of Japan is now on notice. The BoJ has changed its target and is willing to supply whatever quantity of reserves are required to run an anti-deflationary policy, but it is asking for a resolution of "fundamental problems with clear support of the nation for structural reform and under strong leadership of the government of Japan." This is a unilateral declaration. We don't know if the Government has agreed to clean up the structural problems or whether it can pull itself together under "strong leadership." The Civil War in Japan has now been taken to the Government and ultimately to the people of Japan.

IS ANYONE IN THE GOVERNMENT LISTENING?

It is often said that the people get the Government they deserve. The BoJ has changed the stakes by making clear to everyone what it is willing to do. The Voters should be asking, "Where is the Quo for this Quid?"

Documents from the Bank's Web Site are attached below

New Procedures for Money Market Operations and Monetary Easing

March 19, 2001
Bank of Japan

1. Japan's economic recovery has recently come to a pause after it slowed in late 2000 under the influence of a sharp downturn of the global economy. Prices have been showing weak developments and there is concern about increase in downward pressures on prices stemming from weak demand.
2. In retrospect, both monetary and fiscal policies have taken considerably strong actions during the past decade in Japan. Whereas fiscal policy has repeatedly implemented expansionary measures, the Bank of Japan has adopted a policy of maintaining interest rates at levels unprecedentedly low during the history of central banking at home and abroad, thereby providing ample liquidity. All this notwithstanding, Japan's economy has failed to return to a sustainable growth path, and is now faced again with a threat of deterioration.
3. In light of this, the Bank has come to a conclusion that the economic conditions warrant monetary easing as drastic as is unlikely to be taken under ordinary circumstances. Accordingly, the Bank decided at its Monetary Policy Meeting of today to take the following policy actions.

a) Change in the operating target for money market operations

The main operating target for money market operations be changed from the current uncollateralized overnight call rate to the outstanding balance of the current accounts at the Bank of Japan. Under the new procedures, the Bank provides ample liquidity, and the uncollateralized overnight call rate will be determined in the market at a certain level below the ceiling set by the Lombard-type lending facility.

b) CPI guideline for the duration of the new procedures

The new procedures for money market operations continue to be in place until the consumer price index (excluding perishables, on a nationwide statistics) registers stably a zero percent or an increase year on year.

c) Increase in the current-account balance at the Bank of Japan and declines in interest rates

For the time being, the balance outstanding at the Bank's current accounts be increased to around 5 trillion yen, or 1 trillion yen increase from the average outstanding of 4 trillion yen in February 2001 (see [Attachment](#)). As a consequence, it is anticipated that the uncollateralized overnight call rate will significantly decline from the current target level of 0.15 percent and stay close to zero percent under normal circumstances.

d) Increase in outright purchase of long-term government bonds

The Bank will increase the amount of its outright purchase of long-term government bonds from the current 400 billion yen per month, in case it considers that increase to be necessary for providing liquidity smoothly. The outright purchase is, on the other hand, subject to the limitation that the outstanding amount of long-term government bonds effectively held by the Bank, i.e., after taking account of the government bond sales under gensaki repurchase agreements, be kept below the outstanding balance of banknotes issued.

4. The Bank of Japan has decided to implement these policy measures with firm determination with a view to preventing prices from declining continuously as well as preparing a basis for sustainable economic growth.

5. In order to make this monetary easing fully effective in restoring Japan's economy on a sustainable growth path, progress in structural reforms with respect to the financial system, e.g., resolution of the non-performing asset problem, as well as in the area of economy and industry is essential. Structural reform may be accompanied by painful adjustments. Without such adjustments, however, neither improvement in productivity nor sustainable economic growth can be obtained. The Bank of Japan strongly hopes that decisive actions be taken to address fundamental problems both with a clear support of the nation for structural reform and under a strong leadership of the government of Japan.

Attachment

March 19, 2001

Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by majority vote, to change the guideline for money market operations for the inter-meeting period into the following:

The Bank of Japan will conduct money market operations, aiming the outstanding balance of the current accounts at the Bank at around 5 trillion yen.

Should there be a risk of financial market instability, e.g., a rapid surge in liquidity demand, the Bank will provide ampler liquidity irrespective of the guideline above.

March 19, 2001

Bank of Japan

New Procedures for Money Market Operations

- The same benefit of the "Zero Interest Rate Policy" can be expected while leaving room for a market mechanism
- Volatile interest rate fluctuation can be avoided by the "Lombard-Type" lending facility

Strong Commitment in terms of Policy Duration

- The new procedures continue until the CPI (excluding perishables) registers stably a zero percent or an increase year on year
- Affect people's expectation to remove a deflationary bias
- Fall in interest rates across the yield curve

More Effective Market Operations with a Clear Ceiling to Secure Discipline

- In order to provide funds smoothly, increase the amount of outright purchase of the long-term government bonds if necessary
- Secure the credibility of the monetary policy by establishing a ceiling for the purchase set at the outstanding amount of bank note issuance

March 19, 2001
Bank of Japan

Q1: Please explain the new procedures in which the outstanding amount of current account balances at BOJ is set as a main target for money market operations.

A1: The Bank has conducted money market operations based on the guidelines set by the Monetary Policy Meeting of the Policy Board in terms of the uncollateralized overnight call rate. In the new procedures, the Monetary Policy Meeting will decide the guidelines in terms of the "outstanding amount" of current account balances at BOJ and operations will be conducted to meet the target amount.

Q2: What is its impact on interest rates?

A2: So far, the overnight call rate has stayed around 0.15% with around 4 trillion yen of the current account balances. As the outstanding amount of the current account balances will be raised to 5 trillion yen for the time being, the overnight call rate is expected to decline to stay around zero percent under normal circumstances. Furthermore, as market participants expect the procedures to last until "the CPI (excluding perishables) registers stably a zero percent or an increase year on year," we can also expect a decline in interest rates across the yield curve (commitment effect).

Q3: Is this a return to the "Zero Interest Rate Policy"?

A3: Under the "Zero Interest Rate Policy," the Bank adjusted the amount of fund provision to guide a call rate close to zero. In the new procedures, the Bank sets the amount of fund provision as a main target and let market forces decide a call rate. Although interest rates are expected to stay around zero under normal circumstances with 5 trillion yen of current account balances, they could somewhat rise when the market tightens and could reflect a certain difference in a credit risk. As such, the new procedures intend to achieve the same monetary easing effect of the "Zero Interest Rate Policy" while preserving a market mechanism as much as possible.

Q4: More fluctuation in call rates is expected?

A4: No. Thanks to the "Lombard-Type" lending facility introduced in this February, the official discount rate (0.25%) will set a ceiling, beyond which a call rate will not rise.

Q5: Why was monetary base not chosen as a target?

A5: Monetary base consists of the "current account balances at BOJ" and "cash in circulation". In a short run, it is difficult for the Bank to effectively control the amount of cash, which accounts for 90 percent of monetary base, because it is determined by the demand from households and companies. In the case of current account balances at BOJ, the Bank has better control through daily market operations. If we assume a recent growth rate of bank notes (6% annually), it is expected that, by increasing the current account balances to 5 trillion yen, the growth rate of monetary base will rise from the current level (around 3% in February) to 7% within six months.

Q6: The Bank has long opposed to the idea of increasing the outright purchase of the long-term government bonds. Has the policy changed?

A6: No. In the new procedures, we decided to allow an increase in the outright purchase only in the case when such increase is necessary for providing funds smoothly to meet the target current account balances, e.g. when we repeatedly fail to get enough bids for money market operations. The Bank still has no intentions to increase the amount of outright purchase of the long-term government bonds for the purpose of supporting bond prices or government financing. In order to make this point clear, the Bank continues its policy to control the amount of outright purchase of the long-term government bonds with reference to the bank note issuance by establishing a new ceiling on a stock basis.

Q7: Does it mean that the Bank has adopted inflation targeting?

A7: Inflation targeting is usually defined as a scheme under which 1) a desirable inflation rate from a long-term perspective is set as a target and 2) a central bank adjusts monetary policy in a forward-looking manner when an actual inflation rate is expected to deviate from the target. The Bank's policy on inflation targeting is that we have to further examine its desirability and feasibility because it is difficult to numerically define a desirable inflation rate from a long-term perspective in the current situation in Japan. This time, the Bank committed itself that this unorthodox policy will be continued until the actual CPI registers a zero percent or an increase year on year. Although it is not inflation targeting, it shows the Bank's determination to prevent a continuous price decline and to form a basis for a sustainable growth.