Mr Hayami discusses the Bank of Japan's thinking behind the current zero interest rate policy

Speech by the Governor of the Bank of Japan, Mr Masaru Hayami, at the Japan National Press Club in Tokyo on 22 June 1999.

I. Introduction

Four months have passed since February when the Bank of Japan launched its so-called zero interest rate policy, and my speech today explains our thinking behind this historically unprecedented policy.

At the outset, it should be pointed out that all decisions regarding the Bank's policies, including the present zero interest rate policy, are made after deep and wide-ranging discussions by the Policy Board. For example, as can be seen in the recent minutes of Monetary Policy Meetings, when the Policy Board decided upon a zero interest rate policy, it gave serious consideration to such policy alternatives as quantitative monetary easing and inflation targeting. For details of these discussions, the minutes of Monetary Policy Meetings are available.

II. Zero Interest Rate Policy

A. Elements of the Zero Interest Rate Policy

The so-called zero interest rate policy comprises three elements. First, to encourage the unsecured overnight call rate to move as low as possible by providing ample funds. Second, to pay due consideration to maintaining the proper functioning of the market so as to avoid disturbance in the short-term money market. And third, to continue with the current policy until deflationary concerns subside.

Of these three, the first element is a specific directive to guide the interest rate down to around zero. Like the central bank in the US and elsewhere, daily monetary control in Japan is conducted through guiding the shortest inter-bank rate, namely the unsecured overnight call rate. Up to last February when the Bank decided on the zero interest rate policy, the target for guiding the unsecured overnight call rate had already been as low as 0.25 percent, which had left hardly any room for further reduction. Under such circumstances, a view was expressed at the Monetary Policy Meeting on February 12 that for further monetary easing quantitative targeting might be more effective. The majority view, however, was that the demand for monetary base fluctuated widely depending on money market developments and that its relationship with the real economy was not stable. After thorough discussion, it was decided to make the maximum use of the remaining room for the further reduction of interest rates by eliminating the de facto floor for the call rate. Interest rates and the quantity of money are two sides of the same coin. A reduction of interest rates to zero accompanies simultaneous quantitative easing on a massive scale, which expressed by the phrase "provide ample liquidity."

The second policy element is to pay due consideration to maintaining the proper functioning of the market. This means the careful and cautious guidance of interest rates while keeping a close watch on the behavior of market participants and the functioning of the market after the lower limit for the call rate has been removed. Since the call market is an important market

where all transactions in Japan are finally settled, the central bank should at all cost avoid any disruption. In guiding interest rates down to zero the Bank was navigating uncharted waters and hence in the process had to pay particular attention to the effects of the policy change. Since the decision on February 12, the Bank gradually and cautiously encouraged the fall in the call rate while carefully monitoring market developments. By April the unsecured overnight call rate had declined to 0.03 percent and has remained stable since then. This call rate of 0.03 percent can be regarded as the de facto zero interest rate taking into consideration transaction fees.

A conspicuous change in the market structure during this period was the downsizing of the call market from 35 trillion yen to 20 trillion yen, or a decline of approximately 40 percent. The downsizing itself is a result of the large decline in the need for fund-raising in the call market and, in a sense, is a natural reaction of the market mechanism to the ample provision of funds. The question is whether such downsizing has made transactions in the market less smooth. So far we have not observed any problems, but we will maintain a close watch on the impact of our zero interest rate policy on the market function.

With respect to the third policy element that the Bank will continue with the current policy until deflationary concerns subside, this is not in the February 12 decision, but is an expression of the current stance of the Bank's monetary policy based on the majority opinion of the Policy Board. Needless to say, the objective of monetary policy is to contribute to the sound development of the national economy through the pursuit of price stability. In other words, the Bank aims at achieving a situation which is neither deflationary nor inflationary. Therefore, as long as deflationary concerns linger, the Bank should continue with its current monetary easing to achieve price stability and economic recovery. In making clear its stance, the Bank sought to explain to the market, as well as to the public, the objective of its monetary policy in the context of current economic conditions so as to maintain the credibility of monetary policy. Particularly in view of the instability in the financial market that we have experienced from time to time since last year, we thought it necessary to restate the objective of monetary policy to secure market stability. In fact, since I referred to this objective in April, the downward trend has permeated from shorter to longer term interest rates.

B. Effects of the Zero Interest Rate Policy

Since April, the unsecured overnight call rate, the direct target of the Bank's monetary policy operations, has remained stable at around 0.03 percent, or virtually at zero percent. Interest rates on longer terms have also declined sharply in the short-term money market. As a result, a sense of relief regarding fund availability has spread among financial institutions. Also, concern overseas about the availability of funds to Japanese banks has receded significantly, the effect of which has manifested itself in the almost complete disappearance of the Japan premium since March. The permeation of monetary easing seems to have induced liquidity to flow into longer term debt and equities, having a favorable effect on long-term interest rates and stock prices.

Against this background, tightness in corporate funding has eased considerably. Last year, the turmoil in international financial markets and the failure of several Japanese financial institutions impaired the proper functioning of domestic financial markets, making it difficult for even blue-chip companies to raise funds in the market. Financial institutions were obliged to assume a strict attitude toward lending because of not only the constraint on their capital position but also difficulties in their fund raising. All this has changed considerably since

early spring, and we can now safely say that the financial environment as a whole has improved significantly.

It appears that the zero interest rate policy has begun to exert a beneficial influence on strengthening the forces for economic recovery from the monetary side. What are the reasons for this? Simply stated, the monetary easing in February was to reduce the targeted call rate by some 0.25 percent, which was the same as the policy change on September 9 last year in terms of the size of reduction in the call rate. Nevertheless, the effects seem to have perhaps been much larger than generally expected.

One of the reasons for the larger than expected effects is that the zero interest rate policy benefited from the synergy of such favorable factors as an improvement in the international environment surrounding Japan. Last summer, the economic crisis in Russia and the collapse of a major hedge fund in the US triggered considerable tension in international capital markets. The increase in the Japan premium was caused not only by domestic factors but also by such international factors. Fortunately, the tension in international financial markets began to lessen from around the end of last year. On the domestic front, measures to restore Japan's financial system, such as the injection of capital using public funds and the introduction of a special credit guarantee system for small and medium-sized firms substantially contributed to easing tightness in the financial market and corporate funding. In addition to the favorable turn of events, a strong resolve expressed by the Bank to avoid deflation by implementing the zero interest rate policy was a significant contributing factor.

The zero interest rate policy not only had such an effect but also helped to revive, to some extent, the weakened financial intermediation function in Japan as observed last year.

To elucidate the point, let me first describe a 'liquidity effect' of the zero interest rate policy. Whatever the level may be, a reduction in interest rates requires a corresponding increase in liquidity. Reducing the interest rate down to zero means that the central bank will provide enough liquidity so that all the demand for short-term funds will be met in the market. Under such circumstances, the market will reach a stage where there is hardly any liquidity risk for market participants. As was mentioned previously, concern about liquidity increased substantially in Japan's financial markets last year. The zero interest rate policy played a significant role in completely turning around the situation which could be labeled 'liquidity evaporation.'

The zero interest rate policy also had the effect of encouraging risk taking by market participants. Whether indirect financing like bank lending or direct financing, the essence of financial intermediation lies in taking future risks. When financial institutions become excessively cautious, as was the case last year, they will not take even normal risks and the financial intermediation function to support economic activity weakens considerably. As a consequence of the latest decline in interest rates, institutional investors have gradually become more active in investing in securities with longer maturities or those carrying some credit risk such as CP and corporate bonds. Of course, excesses must be avoided and we intend to carefully monitor market developments. In contrast, as regards bank lending, we cannot yet say that a recovery has been seen. Needless to say, we also intend to closely monitor any changes in the attitude of banks toward lending and how such changes might affect corporate funding and investment behavior.

III. Discussions on Zero Interest Rate Policy

A. Zero Interest Rate Policy and Quantitative Easing

We recognize there are opinions that it is not enough just to continue the current policy and that the Bank of Japan should pursue quantitative easing or inflation targeting, or increase the purchase of government bonds to prevent a rise in long-term interest rates.

Regarding quantitative easing, it should be noted that both a reduction in interest rates and quantitative easing are expressions of monetary easing, only from a different point of view. One cannot increase quantity while keeping interest rates constant, and conversely, one cannot reduce interest rates while keeping quantity constant. Interest rates and the quantity of money should be treated as inseparable.

The zero interest rate policy is to encourage the unsecured overnight call rate to move as low as possible by providing ample funds. In this sense, the Bank has already effected sufficient quantitative easing because interest rates have declined to virtually zero.

For example, at present the required reserves for financial institutions amount to some 4 trillion yen per day, but the Bank has been providing more liquidity than the required amount. Recently, we offered to supply funds to the market through our daily operations, but there was not enough demand. The Bank tried to provide additional liquidity, but the market responded "enough." This evidences, in our view, the abundance of liquidity in the market.

Another example. For the past three years, money supply has increased by 60 trillion yen, which is more than ten times the 5 trillion yen increase in nominal GDP. As a result, the ratio of money supply to nominal GDP, Marshallian k, which shows how much money is circulating compared with economic activity, has rapidly risen. The pace of rise matches or exceeds that experienced in the high inflation period of excess liquidity in the 1970s and the bubble period of the 1980s.

As such, current monetary policy has already had a significant easing effect from the quantitative aspect. When quantitative easing is discussed, it sometimes specifically refers to measures which set some numerical targets for quantitative indicators such as money supply. Since interest rates and the quantity of money are two sides of the same coin, the argument can be rephrased as the following technical question: "For monetary easing, is it better to focus mainly on the quantity of money or interest rates as an operational target?"

For example, in an economy where inflationary expectations fluctuate significantly due to such external shocks as an oil crisis, nominal and real interest rates diverge. Thus, focusing only on interest rates runs the risk of making a mistake regarding the degree of monetary easing and tightening. Under such circumstances, it is better to conduct monetary operations guided by quantitative targets such as money supply.

Conversely, in an economy where demand for money greatly fluctuates, setting a quantitative target becomes rather dangerous. Until the latter half of last year, the monetary base, which is the sum of currency in circulation and reserve deposits, had exhibited a high growth rate of about 10 percent on a year-on-year basis. This was because, against the background of anxiety regarding financial system instability, the financial, household, and corporate sectors held a huge amount of liquidity either in the form of cash or deposits with the Bank of Japan. If the

Bank had adopted quantitative targeting under such a situation, it would have meant a tightening of monetary policy which would have been contrary to its policy stance.

There are many other issues to be examined such as the relationship between quantitative indicators and the real economy, the Bank's controllability of such indicators, and the effect of targeting on financial system stability. These issues have been taken up for active discussion by the Policy Board. One Board member even made a specific proposal for quantitative targeting. However, the majority opinion of the Policy Board to date is that it is more appropriate to effect monetary easing by using interest rates as an operational target rather than setting quantitative targets.

B. Zero Interest Rate Policy and Inflation Targeting

The Bank of Japan Law explicitly stipulates that monetary policy aims at price stability. Hence from the viewpoint of pursuing price stability, there would be no conflict between our current conduct of monetary policy and inflation targeting. The difference boils down to whether or not to set a specific numerical target such as a 1 percent increase in CPI.

Since the central bank aims at price stability over the medium to long term, it needs to make a manifold analysis of various factors affecting price developments, such as the risk of future price changes, to come to a judgment. It is dangerous to stick to a specific figure for a specific price indicator as a target. For example, even if a specific target were set, it does not necessarily follow that a policy response would not be required until the actual price index exceeded the target. Depending on the speed of price changes and tightness of supply and demand conditions, there might be a situation where an appropriate policy response would be called for before the price index reached the target.

The currently prevailing argument for inflation targeting includes dissipating the current excessive deflationary expectations of the public by raising their inflationary expectations. Can we really raise inflationary expectations just by announcing an inflation target? Even if we can, there is the danger that long-term interest rates may rise to the point where they have an adverse impact on the economy.

What is the significance of setting numerical targets, be it money supply or inflation, for monetary policy? The answer is to prevent market participants from engaging in unnecessary speculation by clearly showing the Bank's commitment to its policy objective.

If so, without entering the tricky area of setting specific and concrete targets, the Bank can incorporate the usefulness embodied in inflation targeting by making explicit the key elements of monetary policy conduct. It was this line of thinking that was behind the Bank's explicit announcement that it would "continue with the current policy until deflationary concerns subside."

C. Underwriting and the Outright Purchase of Government Bonds by the Bank

Behind the request that the Bank underwrites government bonds, there seems to be the intention that the Bank, through underwriting, should ensure the smooth issuance of government bonds, thereby containing a rise in long-term interest rates. If this is the case, then the Bank holds firm against complying with such a request.

Once a central bank engages in the automatic financing of a fiscal deficit, sooner or later the time will come when it cannot put a brake on money expansion, thereby inducing vicious inflation. This is one valuable lesson that we have learned from history and constitutes the main reason why the underwriting of long-term government bonds is prohibited not only in Japan but also in other industrialized countries.

An increase in the outright purchase of long-term government bonds eventually leads to the same situation as in underwriting. Over time, long-term interest rates are determined reflecting the views of market participants on the future state of the economy and prices. If the Bank were to prevent long-term interest rates from rising despite market pressures, it would have no choice but to increase the purchase of government bonds. Then, inflationary expectations would intensify, putting further pressures on long-term interest rates. Such a vicious circle would repeat itself and the amount of government bonds that had to be purchased would increase infinitely. This would eventually be the same as the underwriting of government bonds.

If a limit on either the amount or the period is set for the underwriting or the outright purchase of government bonds, can we obtain favorable results while avoiding the vicious circle?

The answer is "no" if we consider the mechanism of financial markets and the behavior of market participants. Even if the amount or the period is limited, market participants will always think about what is ahead when they act. It is natural for investors who want to purchase ten-year government bonds to think about ten years ahead. Therefore, once market participants anticipate a rise in long-term interest rates after the pre-determined underwriting or outright purchase is completed, long-term interest rates will in fact rise immediately, not in the distant future. Furthermore, if market participants perceive that a brake has been released in seeing the central bank begin monetizing the fiscal deficit by even a limited amount, there is a risk that the market would become concerned with vicious inflation and loss of fiscal discipline. Given that globalization will continue and that investors worldwide are interested in Japanese government bonds for portfolio management purposes, we should be very careful about our policy operations, while keeping in mind such a market response.

The issue will come to be a matter of confidence in the yen and the Bank's conduct of monetary policy, and eventually confidence in the Japanese economy itself. Confidence would most likely be eroded if the Bank succumbed to the request for the underwriting or increase in the outright purchase of government bonds, with or without a limit on the amount or the period.

Let me turn to the difference between the outright purchase of long-term government bonds currently conducted by the Bank and the recent request to underwrite or increase the outright purchase of government bonds. Our current long-term government bond purchase operations are a way to smoothly provide the long-term funds necessary for sustainable growth of the economy. They are neither aimed at the smooth issuance of government bonds nor for supporting their prices. The Bank makes it a rule to purchase long-term government bonds in the amount roughly consistent with the trend growth rate of banknote issuance over the medium term. By adopting such a rule, the Bank tries not to directly affect long-term interest rates. The Bank will continue to hold firm to the posture that it will not purchase long-term government bonds for smooth issuance or price maintenance purposes.

Relating to this discussion, there are suggestions that the Bank should effect quantitative easing through the purchase of government bonds. In response to these suggestions, monetary easing has already permeated the market and the Bank has sufficient operational tools to effect monetary easing. The Bank does not have to resort to an increase in the purchase of government bonds in the conduct of its current monetary policy.

Since the Bank is providing ample liquidity to the market, related anxiety has almost disappeared in financial markets. However, many investors and financial institutions seem to be experiencing a hard time finding good borrowers and profitable investments. For the whole economy the savings and investment balance is tilted toward huge net savings.

Under such circumstances, if the yield on government bonds records a large increase over a sustained period, it will most likely signal either that views on the economy are turning favorable or that the market is warning against an increase in the budget deficit. In the case of the former, it indicates economic recovery and we welcome this development while staying alert to whether there is any overreaction in the market. In the case of the latter, we should use it as an opportunity to review the costs and benefits regarding the widening of the budget deficit in the context of future economic developments.

D. Reforming the Government Bond Market

Even if the Bank does not underwrite or increase the purchase of government bonds, it does not mean that the government bond market is not important. In fact, the government bond market has become increasingly important. The Bank has long been working actively on the issue of reforming the Japanese government bond market, and it will continue to make the utmost efforts toward that end.

For the Bank, the government bond market is an important market in which its operations, such as repos and short-term government bond operations, are conducted. In addition, the Bank conducts various businesses from the issuance to the redemption of government bonds on behalf of the government, not to mention running the government bond settlement system. From such a standpoint, we have taken a great interest and devoted much effort in improving the functions of the government bond market. In preparation for the introduction of real time gross settlement by the end of 2000, the Bank has been working hard on upgrading computer systems, and, at the same time, formulating new market practices together with market participants.

In general, financial assets with low liquidity which are traded by a small number of investors in the market tend to show excess price volatility. Therefore, making the government bond market more liquid and convenient for many diversified investors is essential to improve functions of both the primary and secondary markets. The importance of reforming the government bond market does not stop here. A highly liquid government bond market in which the market mechanism functions efficiently forms a basis for developing other financial markets. In this regard, we should not underwrite government bonds and contain their prices against market pressures. Rather, we think it important, through improving the functioning of the government bond market, to strengthen financial markets which are the basic infrastructure of our national economy.

We expect that the issues regarding fiscal management and the government bond market will continue to be discussed in various fora, including the Diet. The Bank stands ready to make a contribution by, for example, stating its views.

IV. Current Situation and Prospects for the Japanese Economy

A. Current Situation

While the Japanese economy has stopped deteriorating, there are not yet clear signs of a recovery. There are four reasons behind the halt in deterioration and which can be summarized as follows:

First, an increase in policy-driven demand such as public investment and housing investment has been observed.

Second, under the continued expansion of the US economy, the economic environment overseas has been improving as a whole as illustrated by the gradual recovery of Asian economies and the rebound of international commodity prices.

Third, as a result of such developments in final demand together with the cautious attitude of firms toward production, inventory adjustment has progressed. Judging from current inventories, it appears that conditions are being laid for production to increase once final demand picks up.

Fourth, against the background of our zero interest rate policy and the injection of capital into major banks using public funds, the financial environment has turned favorable.

B. Prospects

Though the Japanese economy has stopped deteriorating, we cannot yet foresee an autonomous recovery. There are three reasons for this.

The first is that the present halt in the deterioration of the economy is basically supported by policy-driven demand like public investment, and private demand, which is the engine for an autonomous recovery, still remains weak. Considering that future demand prospects are uncertain and that balance sheet adjustment is needed to improve soundness and efficiency, particularly among large firms, business fixed investment will very likely further decline in fiscal 1999. In view of the increasing severity of the employment and income environment reflecting aggressive corporate restructuring, it seems difficult to expect any rapid recovery of private consumption from the current situation.

The second reason is that we still need time to carefully monitor how an improvement in the financial environment affects the real economy. It is true that the attitude of financial institutions toward lending has become less strict compared with a while ago, but their balance sheet adjustments and strengthening of risk management systems have not yet reached a stage where they will actively seek loans that carry larger credit risk. Stock prices have been partly supported by such outside factors as rising US stock prices. To ensure the continued improvement of the financial environment and subsequently of the real economy which leads to a virtuous circle between finance and the economy, it is necessary for firms to restructure themselves in a forward-looking manner and to consolidate their business in such a way that will gain the confidence of the market.

The third reason, which relates to the weakness of private demand pointed out earlier, is the persisting pressure of structural adjustment. Needless to say, changes in industrial structure are inevitable for the Japanese economy to become more efficient. Among these changes, employment is one of the most serious problems during the transitional period. In this regard, we welcome the government's initiative to create an employment policy framework which is consistent with the direction of structural reform. Nevertheless, it should be noted that, at least for a short period, there is a possibility of increased downward pressure on the economy from the employment side.

Bearing these reasons in mind, the present situation does not warrant an autonomous recovery of the economy led by private demand in the latter half of this fiscal year when public investment is expected to taper off. Thus, potential downward pressure on prices appears to remain, and it is our judgment that the economy has not yet reached the stage where deflationary concerns have been dispelled.

V. Conclusion

At the present moment, with prolonged worries regarding financial system stability at last subsiding, the Japanese economy stands at an important crossroads. If it can overcome such problems as the changes in industrial structure and unemployment, then an autonomous recovery can be realized. In this regard, we are well aware that monetary policy plays an important role. Based on such recognition, the Bank has committed itself to maintaining its monetary easing policy until deflationary worries subside.

Needless to say, monetary policy alone cannot solve all problems. We should thoroughly recognize that the current zero interest rate policy is an unusual and emergency measure for a central bank and also that we should not indefinitely pursue an expansionary fiscal policy centering on public investment. To truly revitalize the Japanese economy we must forcefully promote structural reform to strengthen the supply side, while sustaining the economy through an aggregate demand policy.

There are various aspects to structural reform, the main purpose of which is to garner the intrinsic potential power of the economy and to raise the medium-term expected growth rate. To these ends, competitive dynamism should be fully utilized. It is thus necessary to create a competitive market environment which encourages firms to boldly pursue technological innovation and explore new business areas. In addition, to take advantage of new investment opportunities, it is essential to have efficient and well-functioning financial markets which enable savings to be smoothly channeled to investment through various financial instruments.

If the changes in industrial structure and reform of the financial system progress and public expectations for growth become more optimistic, our monetary easing policy to date will become even more effective.