

# Japan: End of Zero Interest Rate Policy – Beginning of Long-term Upswing?

In August 2000 Japan's central bank announced the end of the so-called zero-interest-rate policy and raised the overnight interest rate. The bank had always intended to discontinue the zero-rate policy once the threat of deflation had been warded off. Given signs of economic recovery at the beginning of the year, the Bank of Japan now considers this danger to have been largely averted. According to the bank, the dynamism of the world economy and the increase in private investment in Japan are indicators that the days of weak demand are over and that deflationary tendencies have thus been overcome. The slight rise in the interest rate should signal the end of this unique policy – it existed only in Japan – and the country's transition to 'normality'. However, conditions in the Japanese economy are still far from normal.

## Brief flashback: Japan's lost decade

Although Japan's economic performance had long been characterised by high growth rates and low unemployment, not least in comparison to other countries, the country has been faced with extreme difficulties in recovering from the collapse of the 'bubble economy'<sup>1</sup> in February 1990 (cf. figure 1). The subsequent manifest signs of economic crisis and the attempts to cope with the situation are still reflected primarily in the Japanese financial sector.

The speculative bubble economy could only reach such immense proportions because Japanese banks – which have close ties with the public sector – had based their lending only to a limited extent on risk and efficiency criteria. This practice was also initially maintained after the crisis broke. The share of non-performing loans increased and could no longer be blamed only on the burst bubble. Although Japanese banks kept running into insolvency problems, it seems that the state

<sup>1</sup> Speculative transactions and high profit expectations had resulted in an average annual increase in the Nikkei index of 31 percent between 1985 and 1989. A real-estate boom in the same period led to significant price increases. Share and real-estate values were entered, in turn, into enterprise balance sheets, which showed substantial profits thanks to the increased values alone.

continued for some time to undertake far-reaching implicit guarantees for loan default risks.<sup>2</sup> In the following period, the Japanese economy continued to operate under relatively 'soft budgetary constraints'. Regulatory weaknesses and an ineffective penalty mechanism became increasingly obvious.

It was not until 1997 that first indications of a new approach to the continuing problems in the financial sector appeared. In November of that year no fewer than three large banks got into difficulty in the course of the Asian crisis and were actually closed down. Previously – in June – an agenda for the restructuring of the financial sector had been presented (the 'Big Bang' deregulation). These reforms were intended to increase the efficiency of the commercial banking sector, not least by permitting wider diversification of financial services and by investing the supervisory bodies with greater powers. By this time, however, the room for manoeuvre for a relatively smooth reform of the financial sector had diminished considerably. The Japanese economy had already fallen into deep recession (cf. figure 1).<sup>3</sup>

All of this was due in no small part to the fact that economic policy had reacted only half-heartedly to the country's economic problems. Fiscal policy had embarked on a stop-and-go course – one new spending programme after another, each followed by its retraction. Monetary policy, which at the beginning of the 1990s was still characterised by fear of inflation, only gradually loosened up. The national economic crisis was exacerbated by the – sometimes dramatic – appreciation of the yen, which reduced the competitiveness of Japanese exporters.

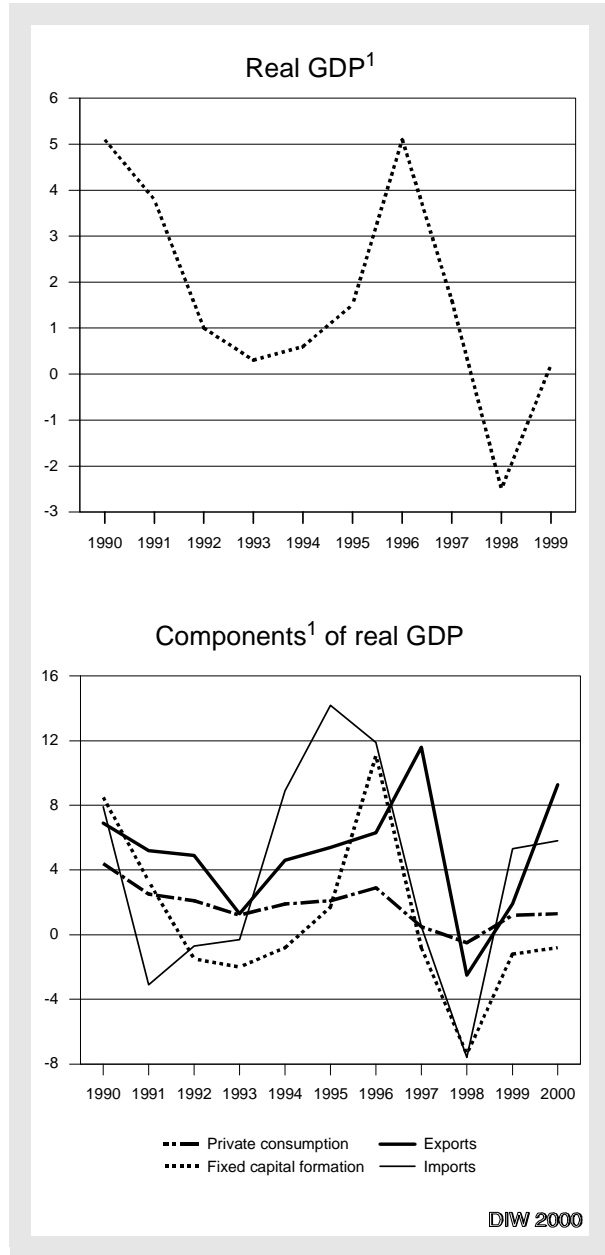
## The idea of a zero-interest-rate policy

Since 1997, the Japanese economy – previously considered extremely flexible and efficient – has been faced with deflationary trends, manifestations of a liquidity trap and signs of a credit crunch. Half-hearted monetary and fiscal policies have had only short-run effects, which eventually evaporated. Despite a discount rate of only 0.5% – unchanged since 1995 – long-term interest rates increased significantly at the end of 1998 (cf. figure 2), owing to the commercial banks' credit rationing and also to their new approach to risk assessment (the so-called Japan premium). The combination of the nominal returns demanded and the appreciation of the yen resulting from the higher interest rates inevitably

<sup>2</sup> A few insolvent credit institutions were also closed down.

<sup>3</sup> 'Japan: Can the Threat of Deflation be Averted?', *Economic Bulletin*, no 7, July 1999.

Figure 1  
**Japan Economic Trends 1990 to 1999**  
 % change on previous year



1) At 1990 prices in national currency.  
 Sources: <http://www.epa.go.jp>; DIW calculations.

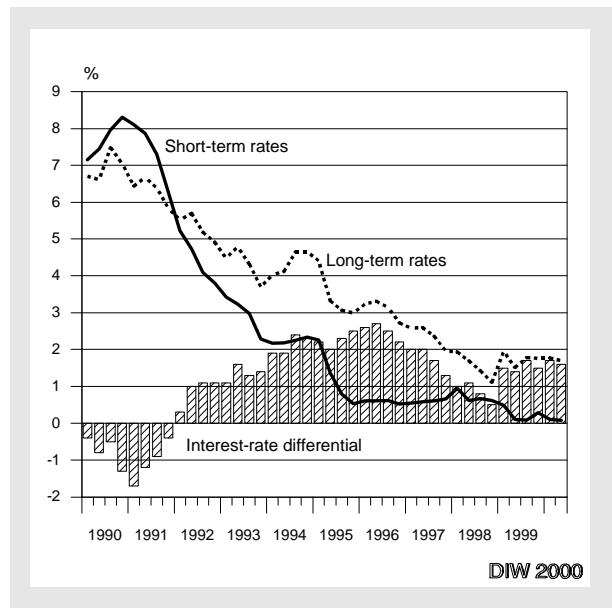
led to a decline in investment, given the uncertain general conditions. Under these circumstances, it was impossible for a long-term upswing to develop.

In view of the magnitude of the economic crisis and the difficulties encountered in dealing with it, in February 1999 the Japanese central bank decided on a radical move – it adopted the so-called zero-interest-rate policy.<sup>4</sup> The aim of this policy was a radical reduction of the

uncollateralized overnight call rate on the interbank market. When the zero-rate policy was implemented, the overnight rate was 0.25%; it was to be gradually pushed down to under 0.15%. The discount rate, by contrast, remained unchanged. In other words, the bank abandoned its discount rate policy and adopted a rather unconventional target variable. In real terms, however, both interest rates, the overnight and the discount rate, remained positive owing to the deflationary trends.<sup>5</sup> In February 1999 they amounted to no less than around 2.2% (overnight rate) and 2.6% (discount rate).

The tool used by the central bank to push down the overnight rate was an accommodating provision of liquidity over an extended period.<sup>6</sup> This policy was supported by the public budget through generous provision of funds to commercial banks facing liquidity problems. And indeed, overnight interest rates rapidly dropped to

Figure 2  
**Short- and Long-term Interest Rates in Japan 1990 to 2000**



Sources: OECD; Main Economic Indicators; DIW calculations.

<sup>4</sup> 'The Bank of Japan will provide more ample funds and encourage the uncollateralized overnight call rate to move as low as possible. To avoid excessive volatility in the short-term financial markets, the Bank of Japan will, by paying due consideration to maintaining market function, initially aim to guide the above call rate to move around 0.15%, and subsequently induce further decline in view of the market developments.' Bank of Japan; February 12, 1999.

<sup>5</sup> Taking consumer price index trends into account.

Table 1  
**Bank Lending to the Private Sector**  
 As of 31 March 2000

	Equity capital <sup>1</sup>	Claims	Equity capital ratio	Pre-tax profits	Return on equity capital <sup>2</sup>	Return on assets (RCA)	Risk-weighted equity capital ratio (BIS criteria)	Non-performing loans as a % of total lending
	bill. USD	bill. USD	%	bill. USD	%	%	%	%
Bank of Tokyo-Mitsubishi	26 019	678 244	3.84	3 831	15.0	0.56	11.46	4.84
Dai-ichi Kangyo Bank	23 525	471 977	4.98	1 704	7.9	0.36	na	na
Sakura Bank	23 057	443 367	5.20	1 192	5.2	0.27	12.53	na
Fuji Bank	22 654	531 184	4.26	2 674	11.9	0.50	11.09	4.37
Sanwa Bank	21 391	428 804	4.99	2 212	10.6	0.52	12.25	4.41
Sumitomo Bank	20 821	507 959	4.10	2 045	10.4	0.40	11.60	6.70
Industrial Bank of Japan	17 000	391 081	4.35	1 578	9.4	0.40	12.19	na
Tokai Bank	15 150	277 688	5.46	1 151	7.6	0.41	12.61	na
Norinchukin Bank	14 795	469 900	3.15	1 100	7.6	0.23	11.39	6.25
Asahi Bank	11 873	271 971	4.37	742	6.3	0.27	na	na

<sup>1</sup> The calculations of equity capital were based on the Bank for International Settlement's (BIS), Basle, definition of 'tier one capital'. — <sup>2</sup> For the purposes of calculation, the average was taken of equity capital at the start and at the end of the year.  
 Source: The Banker, July 2000.

almost zero.<sup>7</sup> As a consequence of this trend, not only the three-month interest rate, but also long-term interest rates decreased. The liquidity problem on the money market appeared to be solved.

The main aim of this unconventional policy was to stimulate demand – by reducing the price of loans and improving the performance of the financial sector – and thus to make a decisive contribution to overcoming the deflationary trends in the Japanese economy. As early as September 1999, however, the central bank realised that the commercial banks were continuing their credit rationing practice despite the new circumstances. Despite falling interest rates, business hardly benefited at all from the policy of 'easy money'; lending to the private sector actually declined (cf. figure 3). The commer-

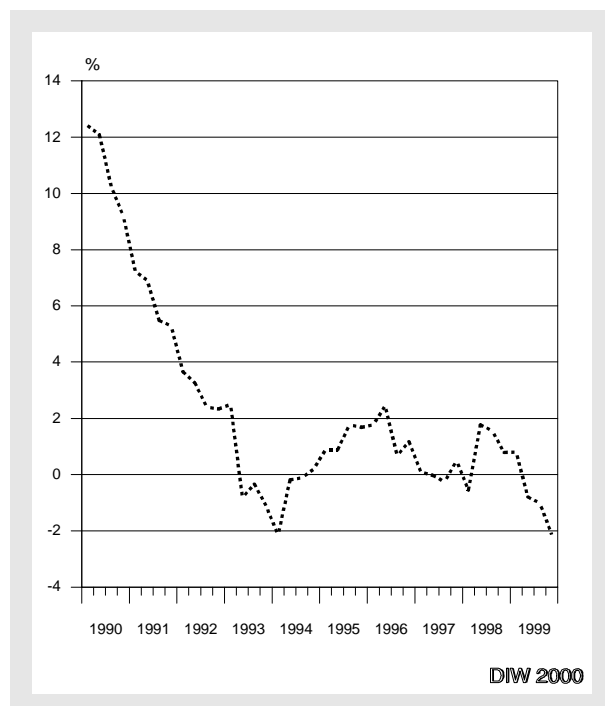
cial banks operating under the new institutional and economic conditions were unwilling to take risks and let their excess reserves pile up in the central bank. In addition, the commercial banks used the favourable conditions to clean up their balance sheets and thus to write off bad debts. It was not least because of this situation that, a year and a half after the implementation of the zero-rate policy, the most important Japanese banks were able to show a profit again (cf. table 1).

Thus, there is now a chance for active financial intermediation by Japan's commercial banks. Whereas in the past the distortions in the financial sector had hampered the transmission of macroeconomic impulses to the real economy, now active financial intermediation could also lead to considerable growth of money supply aggregates such as M2. However, little use has been made of this opportunity so far. Intermediation has expanded only slowly up to now, because of uncertainties about future economic trends and thus uncertainty about returns on investments. Moreover, systemic risks, such as asymmetrical distribution of information between debtors and creditors, also play a role, and these risks are heightened by the continued lack of transparency and efficiency in banking regulations (book-keeping, accounting etc.).

<sup>6</sup> Hayakawa, H.; Maeda, E.: 'Understanding Japan's Financial and Economic Developments Since Autumn 1997', Bank of Japan. *Working Paper Series*. No. 00-1. The Bank of Japan said in September 1999: 'Since the launch of the zero interest rate policy in February, the Bank has continued to provide the financial market with ample funds to guide the overnight call rate as low as possible, currently at virtually zero percent ...'. Bank of Japan, September 1999.

<sup>7</sup> However, transaction costs on the money market prevented the 'zero point' being reached. Organisation for Economic Co-operation and Development (OECD): *Economic Surveys: Japan*, 1999, p. 66.

Figure 3  
**Lending to the private sector**  
 % change on same quarter the previous year



Sources: International Monetary Fund: International Financial Statistics, CD-ROM; DIW calculations.

### The dilemma – departure from the zero-interest-rate policy

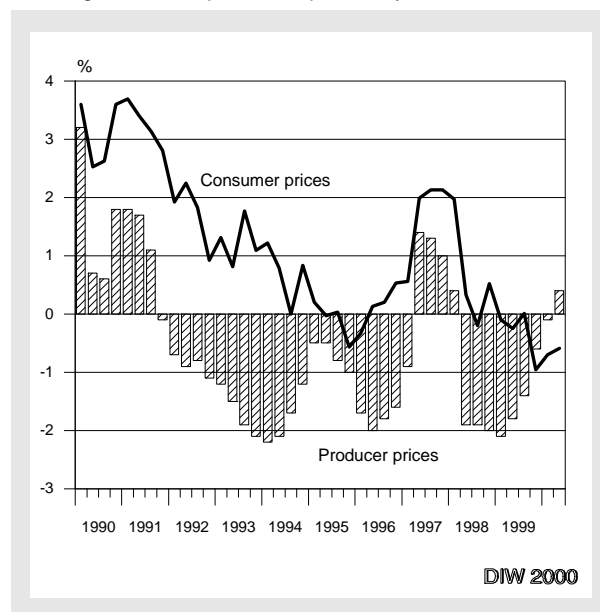
Immediately after introducing the zero-rate policy, the Bank of Japan stipulated the decisive criterion for exiting from this extreme monetary policy measure: overcoming deflationary trends.<sup>8</sup> The end of the policy was to signal the transition to 'normality'. The Japanese central bank had announced that it would carry out the step in the course of this year. However, the dilemma is that a departure of any kind from the zero-rate policy means increased interest rates, which could have a restrictive effect or even lead to new deflationary pressure. This applies all the more where deflationary expectations have not yet been definitively quelled. The choice of the right moment is thus enormously important for the success of this move. By announcing that it will make this step within the next few months, the Japanese central bank has put itself under pressure.

<sup>8</sup> 'The Bank of Japan has been pursuing an unprecedented accommodative monetary policy and is explicitly committed to continue this policy until deflationary concerns subside'. Bank of Japan, September 1999.

In its current report on Japan, the International Monetary Fund (IMF) cautions explicitly against such a change at the present moment.<sup>9</sup> An increase in the interest rate, says the IMF, could stifle the current signs of recovery in their infancy; the central bank should wait until the upswing has stabilised before taking such a step. Despite warnings of this kind, the Bank of Japan ended the zero-interest-rate policy on 11 August 2000. The threat of deflation had been averted, it claimed. The bank's aim is that the overnight rate, which was still just 0.04% on 11 August, should now increase to 0.25%.

If price trends are taken as the operative criterion for whether deflationary trends have been overcome or not, the conclusion must be that the danger of deflation has not yet been forestalled. Although there has been a slight increase in producer prices, until recently, consumer prices were lower than a year earlier (cf. figure 4). The Bank of Japan's main arguments are the improved climate in the world economy, the reforms in the domestic financial sector and the increase in private investment. In fact the Japanese economy started the year remarkably dynamically. In the first quarter of 2000, there was a 2.5% increase in GDP compared with the

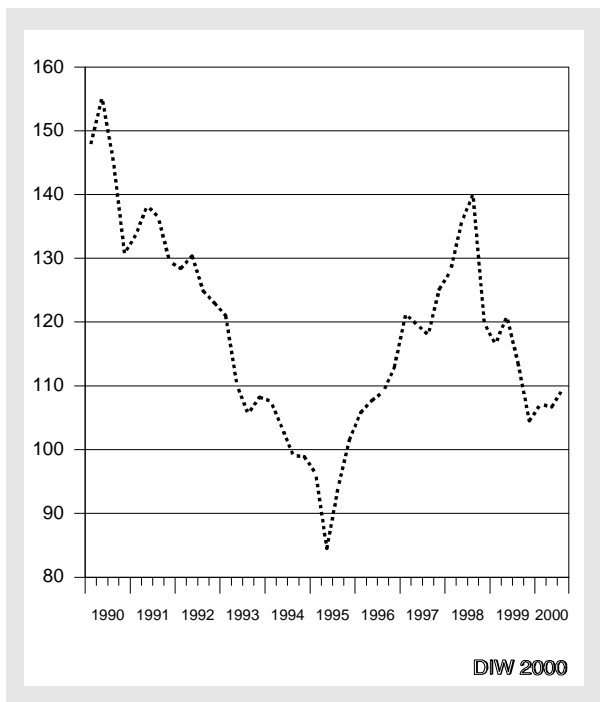
Figure 4  
**Producer and Consumer Prices in Japan**  
 % change on same quarter the previous year



Sources: OECD: Main Economic Indicators; DIW calculations.

<sup>9</sup> <http://www.imf.org/external/pubs/ft/scr/2000/cr0098.pdf>.

Figure 5  
Exchange Rate of the Yen against the US-Dollar  
1990 to 2000<sup>1)</sup>



1) As of 15 August 2000.  
Source: OECD: Main Economic Indicators; DIW calculations.

previous quarter.<sup>10</sup> This dynamic development was based largely on significant export growth (+5.7% on the previous quarter) and substantially increased private investment (+5.1%). However, the increase in private consumption, the most important component of gross domestic product, was much less significant (+1.7%). While the growth in exports is based largely on the strong demand from the Asian region, the increase in private investment is due to the effects of fiscal policy and higher profits in enterprises in view of lower real wages.

The relatively slow increase in private consumption is often said to be linked to the greater uncertainty about future income trends; the restructuring of the private sector was accompanied by an increase in the unemployment rate. The current debate about the ability to finance old-age pension insurance is also contributing to consumer reticence. Against this background, the current signs of recovery must be considered fragile.

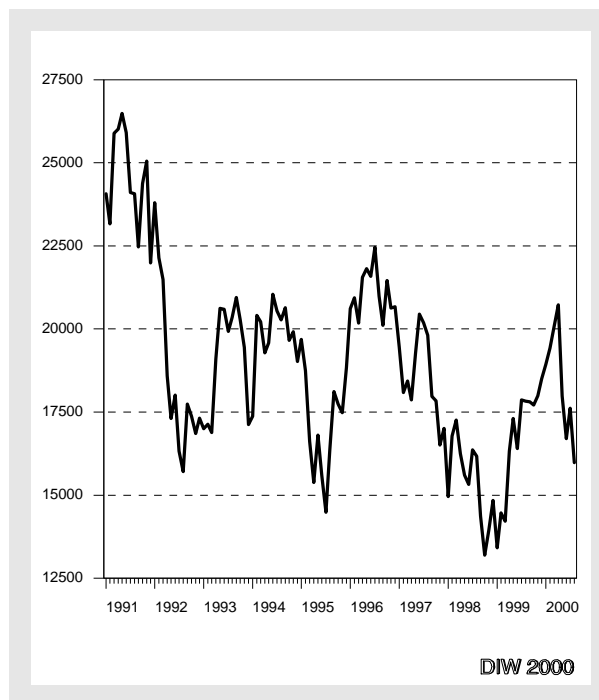
<sup>10</sup> Extrapolation to the annual rate yields a 10.3% increase in GDP. <http://www.epa.go.jp/2000/g/qe001-2/shihanki.gif> (revised provisional estimate for the first quarter of 2000).

## Decision on interest rates a future risk?

The remaining question is why the central bank chose this moment to abandon the zero-interest-rate policy. Most of the figures on economic trends have been known for some time, but there was no move on interest rates. Improved consumer confidence<sup>11</sup> and a substantial increase in contracts for the mechanical engineering industry<sup>12</sup> are recent developments, however. Nonetheless, the fact that the number of firms going bust has recently increased does not support the idea of a stable upswing. Other risks stem from the upward trend of the yen against the dollar, which is by no means justified by the 'fundamental' economic trend indicators (cf. figure 5). Moreover, the current development of the Nikkei index could be an indication of the fragility of the upswing (cf. figure 6).

It is thus not possible to say that the threat of deflation has been permanently overcome. If the central bank decides to abandon the zero-interest-rate policy under the current circumstances, then there is a danger that

Figure 6  
Nikkei 225 Index  
1991 to 2000<sup>1)</sup>



1) As of 10. August 2000.  
Source: Handelsblatt.

<sup>11</sup> <http://www.epa.go.jp/e-e/menu.html>. Published 25 July 2000.

<sup>12</sup> Cf. *Financial Times*, 9 August 2000.

deflationary expectations will burgeon again, which will drive consumers and investors into reticent spending behaviour. Consequently, the danger of an economic setback has increased. However, compared with when the zero-interest-rate policy was introduced, there is now a reformed financial sector which could help provide liquidity to the economy. This move on interest rates would be harmless if the banking sector nonetheless followed a course of active financial intermediation and thus finally contributed to the efforts to overcome the economic crisis in Japan.

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