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Federal Reserve Bank of Cleveland

Beyond Zero: Transparency in the Bank of Japan's Monetary Policy

by Ed Stevens

The Bank of Japan is the central bank of Japan. Its Policy Board has attracted considerable attention because of the unusually low levels of the overnight interest rate—the call rate in the market for unsecured overnight loans of deposits at the Bank—associated with its policy.[1] The Board had targeted a call rate of only 50 basis points (bp) for three years (September 1995 to September 1998) when it eased the target to 25 bp, and then to zero in February 1999. This "zero-interest-rate policy" was interrupted in August 2000 when, in a much-noted reversal, the Bank of Japan raised the target to 25 bp. But that target was lowered again to 15 bp in February of this year before switching to a quantity target in March, which the Bank expects once more to be consistent with a zero call rate.

For a central bank to maintain a zero or near-zero interest rate policy is unusual to say the least, but so, too, are Japan's economic circumstances. The Japanese economy is said to have been in a "funk" since its "bubble economy" of the 1980s burst. Growth in output and employment has been halting. In response, substantial doses of fiscal stimulus have added huge sums to government deficits and debt. After the financial market shocks of 1998, hopeful stirrings of growth were visible. However, in the wake of the current global slowdown, that optimism appears to have been swallowed up in renewed economic softness and deflation. A variety of prescriptions for economic and financial structural reforms have been suggested to enliven the Japanese economy, including monetary policy actions that go beyond maintaining a zero call rate.

The call rate in Japan is the counterpart of the overnight federal funds rate in the United States. The substantial degree of apparent policy ease in Japan since 1998 can be seen when that nation's zero or near-zero call rate is compared with the Federal Open Market Committee's current 3.75 percent funds rate target. "Apparent" is an important qualification here, because of differences in inflation rates. In the United States, the chain index of prices for consumer expenditures rose at a 2.2 percent annual rate in the year ending in April 2001. As an estimate of the expected future rate of inflation, this suggests that the "real" inflation-adjusted policy rate of interest was about 1.6 percent. Over the same period in Japan, consumer prices fell at a 0.5 percent rate. Using this as an estimate of the expected rate of deflation roughly corresponds to a real policy rate of interest in Japan of 0.5 percent.

In addition to suggesting the two policy rates are closer together than they might appear, these comparisons also highlight an important feature of monetary policy: The Bank of Japan was seemingly powerless to ease policy any further once the call rate target had been eased to a zero nominal rate, because policy cannot beget a negative nominal interest rate. Other aspects of monetary policy, however, such as the degree of transparency with which policy is conducted, might enhance its efficiency.

Japan's economy has problems that, undoubtedly, are more complex than monetary policy might be expected to solve. But other kinds of policy actions stand a better chance of success when monetary policy is transparent. Transparency means that market participants' anticipations of central bank actions are congruent with those of policymakers themselves. The Bank of Japan has made repeated efforts toward greater transparency since achieving independence in 1998.

Policy decisions should be transparent. That is, most theorists acknowledge that, although secret policy actions eventually will have an impact, it is more efficient for policymakers to make their decisions known.[2] This enables the public to avoid wasting resources ferreting out the stance of policy. Moreover, greater transparency should provide a basis for the public to form more accurate expectations about the future course of policy—again, to avoid wasting resources through market decisions that are based on invalid assumptions about the future.

This feature of monetary policy is addressed here by describing five episodes during the past three years in which the Bank of Japan attempted to improve its communications with the public. The period begins with perhaps

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the most significant of all changes in recent Japanese monetary policy. On April 1, 1998, as a result of the Bank of Japan Law of 1997, the Bank of Japan ceased existence as an institution tied closely to the Ministry of Finance and began operations as an independent central bank. Independence loosened the institutional link between central bank and government, which might have been interpreted as risking inflationary monetization of large fiscal deficits.[3] According to Article 2 of the same law, "currency and monetary control shall be aimed at, through the pursuit of price stability, contributing to the sound development of the national economy." A general objective for central bank policy is clearly stated, even though no precise definition of price stability is given. Finally, Article 20 of the Bank of Japan Law mandates a basic degree of transparency:

After each Board meeting for monetary control matters, the chairman shall, without delay, prepare a document which contains an outline of the discussion at the meeting in accordance with the decisions made by the Board, and publish the document upon its approval at another Board meeting for monetary control matters.

Transparency and Expectations

Even before April 1998, the Bank of Japan had introduced the framework within which monetary policy decisions would be made as well as made known. This initial framework included an intention to publish a number of documents:

- Six-month-ahead announcements of its twice-monthly meetings
- Announcements of policy decisions immediately after each meeting
- Monthly reports of the Policy Board's view of recent economic and financial developments (two business days after the first meeting in a month)
- Meeting minutes (typically five weeks following each meeting)
- Detailed meeting transcripts "after a period of time," since determined to be 10 years.

In addition, the Bank publishes daily estimates of the supply of its current account balance liabilities, providing market participants with a perspective on call market conditions and daily open market operations. All of this published monetary policy information is readily available on the Bank's Web site, *www.BOJ.or.jp*.

Throughout its new period of independence, the Bank of Japan seems to have moved deliberately toward greater transparency about its policy operations and objectives. Transparency, of course, cannot reveal what a central bank itself does not know. The public's economic decisions are based on expectations for the future, including future policy actions. The price stability objective stated in the 1997 law provides a foundation for expectation formation that should strengthen over time, if the Bank's actions are perceived as consistent with price stability. However, even a credible general objective can leave a lot to the surmise of market decisionmakers.

Policy actions may reflect anticipations of future economic and financial conditions rather than reactions to data describing the past. The public will be concerned with when, how, and how much policy will move, and the extent to which policymakers' anticipations of economic and financial developments are congruent with their own.

Century Date Change

A simple example of an attempt to assist expectation formation—common to other central banks as well—came in October 1999, in anticipation of potential century-date-change problems. Market participants might have envisioned computer and telecommunications failures that would prevent sending or receiving funds needed for financing. Such concerns already appeared to be driving up interest rates for term financing that spanned the end of 1999. At its October 13 meeting, the Bank of Japan acknowledged these market concerns and took temporary measures to reassure markets of its commitment to provide ample funding at year-end, should problems warrant; it would do so by lending and by expanding both the range of securities it might acquire and the number of counterparties with which it would deal. In the event, of course, Y2K came and went without widespread problems.

On Current Monetary Policy

A more substantial example came earlier in 1999. Intimations of economic recovery appeared at the end of the summer, but the exchange value of the yen had surged for reasons that were not entirely clear. The government was concerned with combating yen appreciation. Its representative at the September 21 Policy Board meeting requested that the Bank "give due consideration" to potential effects of appreciation on the economy and "take appropriate monetary policy measures." The chairman of the Policy Board had met with the minister of finance a few days previous, a move that suggested to some that agreement might have been reached for special Bank of Japan assistance in countering yen appreciation. Members of the Policy Board discussed "how monetary policy could be implemented to deal with the yen's appreciation," a process that typically involves easing policy. Discussion moved on to how a zero-interest-rate policy could be eased any further, "the possibility that the market already expected the Bank to take further policy action at the meeting," and "views on additional policy measures." The majority agreed that maintaining the zero-interest-rate policy was the appropriate decision.

Minutes of the meeting, which would have explained the Board's reasoning, were not scheduled to be released for more than a month. "Members...discussed the relation between market expectations and monetary policy in view of the possibility that the market already expected the Bank to take further policy action at the meeting." Some members observed that "the Bank's policy decisionmaking process and the degree of monetary easing under the zero interest rate policy were not fully understood. On these grounds, the members suggested the release of a statement on the current monetary policy, although the policy was not changed, followed by a press conference by the chairman." The result was the immediate release of *On Current Monetary Policy*, a condensed report of the Board's discussion of relevant issues that was intended to bring greater consistency between central bank and market anticipations for the future.

On Price Stability

In mid-2000, economic conditions appeared to be improving. The policy announcement released after the July 17 meeting indicated that, although the zero-interest-rate policy had not been lifted, "the majority of the Policy Board views that Japan's economy is coming to a stage where deflationary concerns are dispelled, which the Board have clearly stated as the condition for lifting the zero interest rate policy." After its August 11 meeting, the Bank announced that not only had it ended the zero rate policy, it also had rejected a government request (a statutory right) to postpone that decision.

The summer of 2000 illustrates the Bank of Japan's efforts to achieve greater transparency, not only about the policy-decision process, but also about a vexing policy problem: What is price stability? The published minutes of Policy Board meetings show that, throughout 2000, members seriously discussed the meaning of price stability, reliable measurement of price levels, and the appropriate set of prices to stabilize. All of these questions were being addressed in a zero-interest-rate environment where deflation and economic contraction were immediate concerns. A number of staff research papers addressed these questions, drawing on a growing body of relevant international academic research literature. In October 2000, the Bank of Japan published a summary of its understanding of the policy situation, including major unanswered questions, in *On Price Stability*.[4]

Outlook and Risk Assessment

One conclusion of *On Price Stability* was that releasing the Policy Board members' forecasts of the economy and prices would give the public a firmer basis for forming expectations of future policy. These forecasts would extend beyond the immediate future typically covered in the Board's *Monthly Report of Recent Economic and Financial Developments* and minutes of its policy deliberations. To implement this, the Policy Board inaugurated publication of *Outlook and Risk Assessment of the Economy and Prices*, a twice-yearly release that must be approved by a majority vote of the Board. It elaborates on the Board's outlook for the economy, financial markets, and prices over the ensuing year or so. The risk assessment discusses the broad assumptions underlying the outlook under the current stance of policy and major factors that might alter the outlook. Tables are appended to this text that show the range of members' numerical forecasts of the rate of change of GDP, wholesale prices, and consumer prices.

New Procedures for Policy Operations

Throughout the Bank of Japan's initial three years, some policy commentators suggested that a zero-interest-rate policy, even richly communicated to the public, could be eased further. These suggestions included a quantitative, perhaps ever-increasing target for growth of central bank money, supported by more extensive outright purchases of long-term government securities, and a quantitative target for the inflation rate. On March 19, 2001, the Policy Board communicated its intention to adapt policy operations in the direction of these suggestions, "with a view to preventing prices from declining continuously as well as preparing a basis for sustainable economic growth."

First, the Bank replaced its target for the overnight call rate with a target for the quantity of current account balances held at the Bank by financial institutions. The initial target has been around Y5 trillion, which exceeds the volume of required reserve deposits by about Y1 trillion, and is said to be comparable to the actual volume of balances that the Bank supplied when it was maintaining a zero call rate. Moreover, the Japanese central bank indicated its intention to supply an even more ample supply of balances "should there be a risk of financial market instability, e.g., a rapid surge in liquidity demand." Compared to a zero-interest-rate target, the Policy Board's discussion suggests the quantity target should ensure that, when the economy and demand for reservable deposits begin to pick up, market demand should put upward pressure on the call rate. Letting the market "speak" in this way may forestall any latent fears of future inflation.

Second, the Bank of Japan had been limiting monthly purchases of long-term Japanese government securities to the amount by which currency grew. This limit was relaxed, ensuring more scope for maintaining current account balances if, for example, extremely low levels of money market interest rates were to make bidders indifferent to bidding in normal reserve supplying operations. While relaxed, a limit remains in the form of a cap on total holdings of long-term government securities equal to the total outstanding amount of the Bank's currency liabilities. This can be viewed as an assurance that the Bank's expansionary policy will stick to the statutory price stability objective and will not slide into inflationary finance of large government deficits.

Third, the Bank of Japan stated its intention to maintain the new quantity targeting procedure "until the consumer price index (excluding perishables), on a nationwide statistics [sic] registers stably [sic] a zero percent or an increase year on year." This was an important intention to communicate. When the first zero-interest-rate policy was adopted in February 1999, the Bank set no quantifiable, publicly observable condition for its duration. In policy discussion, emphasis remained on the immediate economic and financial outlook. The new condition implies that the public will be able to see more clearly when policy operations might be expected to change.

■ Conclusion

Japan's economy has problems that undoubtedly are more complex than a central bank might be expected to solve. In its short history of independence, however, the Bank of Japan has shown considerable flexibility in adjusting the ways it communicates policy intentions to the public. Making monetary policy more transparent represents on important contribution to a better future for the Japanese economy.

■ Footnotes

1. The effective floor under the nominal call rate is slightly more than zero, as measured on the "ask" side of the market. This reflects a cost of about 2 bp to make a call loan.

2. Exceptions are developed in a recent paper by Henrik Jensen, "Optimal Degrees of Transparency in Monetary Policymaking, "University of Copenhagen and Centre for Economic Policy Research, 2001.

3. The 1997 law did not sever all institutional connections between the Bank of Japan and the government. The Bank must report on Policy Board decisions to the Diet every six months. More directly, Article 19 says:

1. The Minister of Finance and the Minister of Economic Planning Agency may, when necessary, attend and express views at those Board meetings for monetary control matters, or each of them may designate a staff member of his Ministry or Agency to attend and express views at such meetings.

2. The Minister of Finance (or his designated delegate) and the Minister of Economic Planning Agency (or his designated delegate), when attending the Board meetings for monetary control matters, may submit proposals regarding monetary control matters, or request that the Board postpone a vote on monetary control matters until the next Board meeting of this type.

3. If a request is made to postpone a Board vote under the provisions of the preceding Paragraph, the Board shall decide whether or not to accommodate the request, in accordance with the same voting procedures which apply to other matters.

Moreover, according to Article 51:

1. Every fiscal period, the Bank of Japan shall prepare a budget for general and administrative expenses (those prescribed by a Cabinet Order as not hampering the currency and monetary control, hereinafter referred to as "a current expenditure budget"), and submit it to the Minister of Finance for his or her authorization before the business year begins.

4. Planned research workshops in 2001, specifically aimed at price-measurement issues, were announced in March 2001. This is a particularly hot topic because some analysts contend that, as a measure of inflation, the rate of change in the Japanese consumer price index is biased upward. If so, a zero measured rate of inflation effectively would amount to deflation. However, others contend there is a downward bias. Further complicating the picture is the extent to which movements in asset prices (as well as output prices) should be part of the price stability objective.

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