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Monetary*Trends*

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Interest Rate Targets Abandoned

In March 2001, the Bank of Japan (BOJ) announced that it would no longer target the uncollateralized overnight call rate, which is similar to the U.S. federal funds rate. Instead, the BOJ now targets the outstanding balance of current accounts at the BOJ, which is similar to the reserve component of the U.S. monetary base, and has stated a goal of increasing current account balances by 25 percent (from 4 to 5 trillion yen) over the next six months.

Because the overnight call loan rate was approximately 0.15 percent when the BOJ announced its change in policy, many commentators already viewed Japan's monetary policy as exceptionally easy. Many argued that low interest rates left the BOJ with little room to ease further. Such statements, however, fail to recognize that monetary conditions are not necessarily easy when nominal interest rates are low—even exceptionally low.

Economists have long recognized that the level of nominal interest rates can be a misleading indicator of the stance of monetary policy. Inflation expectations and the growth of real economic activity influence the level of interest rates. If expected inflation declines or economic activity slows, nominal interest rates tend to fall unless the central bank attempts to offset these forces. If the central bank desires to maintain the current level of its overnight interest rate target, it must drain reserves from the banking system, which could result in a slowing of monetary growth.

Central banks usually lower their interest rate target when economic weakness or disinflation put downward pressure on interest rates. But, unless the central bank lowers its target sufficiently, the growth of bank reserves and the money stock could decline. In such circumstances, the behavior of interest rates and the growth of monetary aggregates can give conflicting signals. The reduction of the target rate suggests that policy has eased, whereas a slowing of the growth of reserves or the money stock suggests that policy has tightened. This conflict is often most apparent during periods of extreme economic distress.

Confusion over the meaning of low nominal overnight interest rates in Japan today is similar to confusion over the meaning of *high* nominal interest rates in the United States during the 1970s. During most of the decade, the Fed implemented monetary policy by targeting the federal funds rate. As inflation accelerated and market interest rates rose, the Fed followed suit by raising its federal funds rate target. For example, from early January 1978 to September 1979 the Fed raised its target for the federal funds rate by 5 percentage points from 6.5 percent to 11.5 percent. Many commentators interpreted these actions as a substantial tightening of monetary policy. Despite sharply higher interest rates, however, the growth rate of monetary aggregates and the inflation rate increased. By monetary growth measures, monetary policy was becoming easier, not tighter. The Federal Reserve eventually recognized that it had not tightened enough to subdue inflation, and in October 1979 the FOMC adopted new procedures designed to bring inflation under control by slowing monetary growth.

The case of Japan differs only in direction. In an economy with persistent deflation and negative output growth, declining or low nominal interest rates do not necessarily indicate easy monetary policy any more than high nominal interest rates signal tight monetary policy when output growth and inflation are rising. In adopting a monetary aggregate targeting procedure with an explicit target for reserve growth, the BOJ is signaling a willingness to pursue aggressive policies to combat economic weakness regardless of the level of the overnight nominal interest rate.

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