Japanese Monetary Policy

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by Allan H. Meltzer

Japan stands out among the major economies of the world for many reasons. Not least among them should be its monetary achievements of the last decade. In the middle seventies, Japan experienced inflation as high as 20%. As late as 1980, consumer prices rose by 8%. Inflation rates now range between zero and 3%, depending on the broad measure of inflation chosen. Of greater significance for the rest of the world is the fact that wages and salaries rose less than productivity, so that unit labor costs fell by 5% in 1984 for the second year in a row. If the annual spring labor offensive results in money wage increases of about 5 1/2% or less, as now seems probable, unit labor costs will decline again in 1985. Japan's costs of production are, therefore, likely to remain low relative to the United States.

Brief History

Inflation has fallen in all the industrialized countries during the 1980's, but Japan is the only major country that was able to reduce inflation without having a recession. In fact, growth of real output has remained between 3 and 5% in each of the past five years.
During the same period, by way of contrast, growth of real output in the U.S. has varied over a range three times as wide -- 6% to -1.5%.

Monetary policy contributed to the relative stability of the Japanese economy, just as it has contributed to the relative instability of the U.S. economy. Since July 1978 the Bank of Japan has publicly announced a "monetary projection" each quarter. Unlike the Federal Reserve, the Bank has not chosen to announce projections or targets for three or four different aggregates. Research by the Bank's economists suggests that in Japan there is a closer relation between money and spending over long periods if money is defined broadly, to include time deposits and CDs, so the Bank projects only one aggregate, M2 + CDs.

Each quarter, the Bank announces its projection for the four quarters ending one quarter ahead. Generally these announcements show a declining trend, but there have been exceptions. Over the whole period, however, there is a marked decline in the growth rate of all monetary aggregates. Chart 2 shows the data for M2 + CDs. Also shown are growth rates for nominal GNP and for real GNP. The difference between the latter two growth rates is the rate of inflation, measured by the rate of growth of the GNP deflator. Note that all rates of growth are computed from the same quarter of the previous year, not from the previous quarter.
Chart 2

MONEY STOCK AND GNP (NOMINAL AND REAL) IN JAPAN

Note: 1) Growth rates of money stock and GNP are calculated not against the previous quarter, but against the same quarter in the previous year.

2) "M2+CD" data (before 1979/I, "M2" data) are an average of end-of-month observations. For example, the first quarter is an average of the data at the end of January, February and March.
The solid line drawn at first quarter 1975 marks the point at which the Bank of Japan began to control money growth. Before that date, the Bank paid much less attention to money growth. Growth rates of money fluctuated between 15% and 25%. Growth rates of nominal and real GNP were just as variable.

Since 1975, monetary variability has been reduced, and the trend growth rate of money -- M2 + CDs -- has declined more or less regularly. Money now grows at half the rate of 1975-76 and money growth is less variable.

The change in monetary policy has had two effects that are visible in the chart. First, the rate of inflation has fallen, more or less steadily. This is shown by the narrowing of the spread between growth of real and nominal GNP. Second, real GNP growth has become much less variable. The wide swings of the 1950's, 1960's and early 1970's are no longer visible. Real growth now remains in the 3 to 5% range with neither recessions nor major booms.

Operating Procedures at the Bank of Japan

The Japanese manage their money stock to achieve price stability. Emphasis on price stability as the main objective of monetary policy began after 1975. Mr. R. Shimamoto, Executive Director of the Bank of Japan explains why the change was made.

"Before about 1975, there was no clear separation of indicators and policy objectives... Rather, interest rate and quantitative adjustments were implemented with an eye on many policy objectives, such as credit conditions, interest rates, quantities lent, prices, output, and the balance of payments. However, the escalation of inflation in 1972-73 demonstrated the existence of a close relation between money supply and prices. ... [T]he money supply took on much greater importance as the key medium-term indicator, sitting between interest rates as the operating target and final goals."

The Bank avoids the disruptive effects of faulty seasonal adjustment procedures by stating its projection as an annual growth rate measured from the same quarter of the previous year. Use of the annual growth rate directs the Bank's and the market's attention to the trend in money growth and avoids the excessive attention given in the United States to transitory fluctuations in the money supply. Spokesmen for the Bank have stated publicly that one main reason for announcing projections is to stabilize public expectations about future inflation, so procedures are chosen with that aim in mind.

The Bank controls money in two ways. One is traditional central banking practice, and the other is distinctly Japanese. The traditional method is the adjustment of short-term interest rates on the call market and the Treasury bill market by open market operations, changes in rediscount rate and in reserve requirement ratios. Lending to Tokyo banks has been the most important source of reserves, so changes in the discount rates relative to open market rates have a significant effect on the volume of discounts. At times, the Bank has supplemented this method of monetary control by using "window guidance." In practice, window guidance means that the Bank imposes direct controls on lending by the principal (Tokyo) banks as a price of admission to the discount window. Since Tokyo banks borrow a very large (but declining) share of their total reserves from the Bank at below market rates, window guidance gets a quick response. However, window guidance fixes the shares of the Tokyo banks and reduces competition, so it is used much less now than in the past.

The discount rate has remained at 5% since 1982. The Bank's principal means of changing the money stock is to absorb or increase reserves by open market operations. By withdrawing reserves and reducing discounts, the Bank raises the interest rate on the call money market (similar to the Federal funds rate), and by increasing reserves the Bank lowers the call money rate. In practice, the Bank has not found it necessary to vary the call rate over a wide range. Since mid 1982, the quarterly average call money rate has remained between 5 3/4 and 7%. In contrast, the U.S. Treasury bill rate has ranged between 7 3/4 and 10 1/2% during the same period.
Results

The monthly data show that not only money growth rates shown in Chart 2 but also interest rates have been more stable in Japan than in the United States. For example in 1984, the monthly average call money rate in Japan varied between a peak of 6.45% and a trough of 5.74% while the U.S. Treasury bill rate varied between 7.75% and 10.60%.

### Japanese and U.S. Interest Rates

<table>
<thead>
<tr>
<th>1984 Monthly</th>
<th>Japan Call Money</th>
<th>U.S. Treasury Bills</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>6.05</td>
<td>8.87</td>
</tr>
<tr>
<td>February</td>
<td>6.04</td>
<td>9.13</td>
</tr>
<tr>
<td>March</td>
<td>6.45</td>
<td>9.76</td>
</tr>
<tr>
<td>April</td>
<td>5.88</td>
<td>9.68</td>
</tr>
<tr>
<td>May</td>
<td>5.74</td>
<td>9.83</td>
</tr>
<tr>
<td>June</td>
<td>5.91</td>
<td>9.77</td>
</tr>
<tr>
<td>July</td>
<td>6.03</td>
<td>10.01</td>
</tr>
<tr>
<td>August</td>
<td>6.11</td>
<td>10.60</td>
</tr>
<tr>
<td>September</td>
<td>6.32</td>
<td>10.27</td>
</tr>
<tr>
<td>October</td>
<td>6.15</td>
<td>9.38</td>
</tr>
<tr>
<td>November</td>
<td>6.10</td>
<td>8.59</td>
</tr>
<tr>
<td>December</td>
<td>6.41</td>
<td>7.75</td>
</tr>
</tbody>
</table>

Source: OECD Main Economic Indicators March 1985

The lower variability of Japanese short-term rates carries over to long-term interest rates. This greater stability is achieved in large measure because market participants are confident that the Bank will come close to its monetary projections and will set its projections to keep inflation low. Confidence in the Bank is apparent in the public discussion of monetary policy. Announcements of monetary projections are not followed by market speculation about the meaning of the Bank's announcement. The use of a single aggregate and a history of keeping money growth close to projections makes the Bank's statements highly credible.
Japanese unions appear to share this confidence in the Bank's commitment to non-inflationary growth. Their wage demands are based on a belief in continued low inflation.

By keeping inflation low and by avoiding major swings in interest rates, the Bank helps Japanese producers to plan over a longer horizon. Relative stability of interest rates and steady low rates of inflation reduces risk premiums and, thus, lowers interest rates. Long-term rates of interest in Japan are now 4 to 5 percentage points lower than long-term rates in the United States.

Differences in recent rates of inflation in the U.S. and Japan account for no more than half the difference in long-term rates. The remaining difference reflects differences in risk premiums (arising from greater fluctuations in money growth and rates of interest), differences in anticipated future inflation and, possibly differences in taxation of interest income. The differences in interest rates arising from differences in risk is a disadvantage for U.S. producers since it raises the cost of capital in the U.S.

Exchange Rates

A common belief in the U.S. is that the Bank of Japan intervenes to lower the market value of the yen and gain a trade advantage. There is no evidence that this belief is correct. In fact, the opposite view is closer to the truth. In recent years, when the Bank has intervened to affect the exchange rate, it has mainly been in an effort to appreciate the yen against the dollar. A main reason for this intervention is concern about trade restrictions.

To say that the Bank intervenes is not to say that it succeeds in adjusting the exchange rate. Buying or selling foreign exchange instead of domestic securities does not have a noticeable effect on the exchange rate. If the Bank aims at a monetary growth rate and is expected to achieve its target, it is of second or third order of importance whether the Bank supplies the reserves by buying foreign instead of domestic assets. The main difference is the ownership of various assets. If the Bank supplies the same growth of bank reserves and money by purchasing dollars, the Bank holds more dollar securities and the market holds more domestic assets. The effect is to shift the risk of exchange rate changes from the market to the Bank.
To change the exchange rate by intervention, the Bank must change the growth of reserves and money. To depreciate the yen against the dollar, the Bank must inflate more than the U.S. This is the very opposite of what the Bank set out to do in 1975, and it has largely achieved its objectives at substantially lower cost and with greater credibility than other central banks. Japan has benefitted.