



Bound by a Hidden Agenda: The Birth and Consequences of the Bank of Japan's Quantitative Monetary Easing

Tetsufumi Arita

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The Walter H. Shorenstein
Asia-Pacific Research Center
Freeman Spogli Institute for International Studies
Stanford University
Encina Hall
Stanford, CA 94306-6055

<http://shorenstein.stanford.edu>

About the Author

Tetsufumi Arita has been a reporter for the Japanese newspaper, *Asahi Shimbun*, since 1990. He has extensive experience in reporting business and political news. Arita was a visiting fellow at the Walter H. Shorenstein Asia-Pacific Research Center between 2004 and 2005.

Abstract

For the past five years, the Bank of Japan (BOJ) has employed an unconventional monetary easing policy, called quantitative monetary easing. Under a zero interest rate regime, the BOJ shifted its tool for monetary easing from interest rates to quantity of money, thus providing the money market with much more money than it needs. It is difficult to find evidence that this monetary easing has contributed to the current economic recovery. What we can show is that this quantitative easing diluted the functions of interest rates in the money market, with the following consequences: quantitative easing hid the risks of the huge amount of fiscal debt and supported troubled commercial banks. Hence it helped to prevent both fiscal and financial crisis.

How did such a policy come about? It is misleading to suppose that the BOJ, which gained legislative independence in 1998, decides its policy on its own, or, conversely, to assume the government controls the BOJ completely. The conflict between the BOJ and the government should be carefully examined. In that sense, these two consequences have different stories. Preventing fiscal crisis had been an implicit agenda from the beginning of the conflict between the BOJ and the government. The BOJ tried to reject this implicit agenda at first, but finally accepted it to compensate for its own political failure in raising interest rates. The process shows that this implicit agenda has gradually become explicit. By contrast, supporting troubled banks was an unexpected consequence, which in the end helped the BOJ to defend its policy.

The situation has become complex amid the current economic recovery. The need to restore the function of interest rates has been rising. The need to support troubled banks has decreased, but supporting the fiscal debt still remains critical issue, since it has grown to a dangerous amount. Monetary policymakers therefore face a contradiction. Strategies for separating monetary policy from the management of government bonds, while avoiding fiscal crisis, are needed.

Key Findings: An Implicit Agenda Underlies Monetary Policy

This paper examines the relationship between quantitative monetary easing and fiscal debt, with the following findings:

- (1) The BOJ's quantitative monetary easing, which has continued since 2001, has not been as successful as expected in boosting the economy as a whole.
- (2) This monetary policy has had another important, but implicit, agenda: preventing a fiscal crisis as a result of accumulated debt. In that sense quantitative monetary easing was effective in helping to stabilize bond markets.
- (3) This implicit agenda, which the BOJ adopted after considerable turmoil, has gradually become more explicit. This is in part because bond markets have settled down, and in part because the BOJ gave up trying to distance itself from the government.
- (4) Japan's policymakers face a dilemma as economic recovery progresses. If the BOJ quits this policy and raises interest rates in order to normalize the interest function, fiscal stability could suffer.
- (5) Strategies for separating monetary policy from the management of government bonds are needed.

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The financial unrest that assailed the Japanese economy between 2001 and early 2003 seems to have settled down. Japan's growth of gross domestic product (GDP) in fiscal year 2003 was 2.0 percent, and 1.9 percent in fiscal year 2004, after poor performances in fiscal years 2002 (−0.8 percent) and fiscal year 2001 (−1.1 percent). Since the current recovery has come about without additional stimulus provided by government spending, it is considered to be autonomous, compared to the past two recoveries after the the bubble economy burst in 1990. However, it seems that outside support—including the BOJ's monetary policy—is still the source of this recovery. Monetary easing by the BOJ helped minimize risks of the public finance, private banking, and industrial sectors by suppressing the function of the market. The government reinforced this suppression by taking other measures to support private banks and large firms. Interestingly, most of these measures were associated with finance rather than government spending.

This paper seeks to examine the influence of monetary policy on markets and to explore the decision-making process that underlies that policy. Part 1 presents an overview of the influence that monetary easing and other supplementary measures had on markets and business, and demonstrates that these measures have advantages as well as risks. Part 2 describes the process that shaped the monetary and economic policy of that period. This process explains how actors' behavior resulted in monetary easing. Part 3 concludes with suggestions for dealing with future risks, which may be hidden in this period of economic recovery.

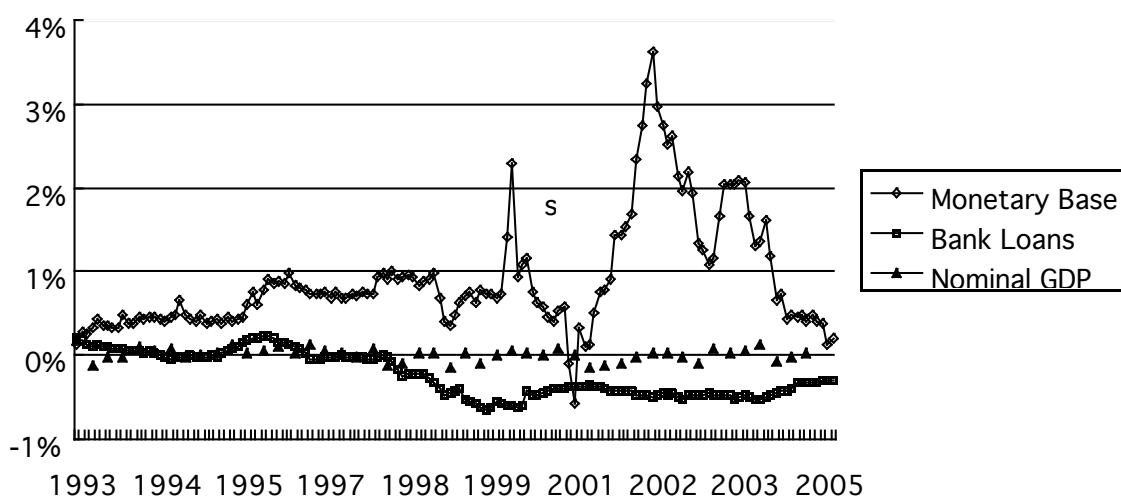
1. Influence of the Quantitative Monetary Easing over Markets

Brief Description of Monetary Policy from Zero Interest Rate to Quantitative Easing

Before delving into the main story, a brief description of the BOJ's monetary policy during this period is needed. The BOJ plunged into a zero percent interest rate policy in February 1999. The policy made the overnight call rate zero percent through market operations, in which the BOJ buys or sells bills. Though the BOJ got out of this zero percent interest rate policy in August 2000, the overnight call rate remained at 0.25 percent—still close to zero. As the economic depression worsened, the BOJ launched a quantitative monetary easing policy in March 2001. Usually, central banks help control the economy by adjusting interest rate. However, quantitative monetary easing—which appeared to be a new measure to boost the economy—was intended to directly control the quantity of money, instead of the interest rates. The quantity of bank reserves and the money that private banks put in the BOJ for emergencies, became the target of the operation. That amount, which began with ¥5 trillion in March 2001, increased continually, finally reaching ¥30 trillion.

Unlike traditional monetary easing measures, which increase the money supply through bank lending and thereby boost the economy, the efficacy of the zero interest rate policy and quantitative monetary easing was not clear. Masaya Sakuragawa pointed out that bank lending was decreasing in spite of these monetary easing measures and concluded that the BOJ's monetary policy did not necessarily contribute to this period of economic recovery.¹ Figure 1 shows that bank loans and nominal GDP have flattened or declined in spite of the rise of monetary base. Yet this does not mean that monetary easing did not influence the economy. Rather, it played an important role in stabilizing the prices of long-term Japanese government bonds and supporting commercial banks.

Figure 1. Monetary Base, Bank Loans, and Nominal GDP



Sources: Bank of Japan; Nikkei Telecom. See <http://www.boj.or.jp/type/stat/dlong/fin_stat/boj/cdab0150.csv> for monetary base and <http://www.boj.or.jp/type/stat/dlong/fin_stat/zan/cdab0930.csv> for bank loans. Accessed April 2, 2007.

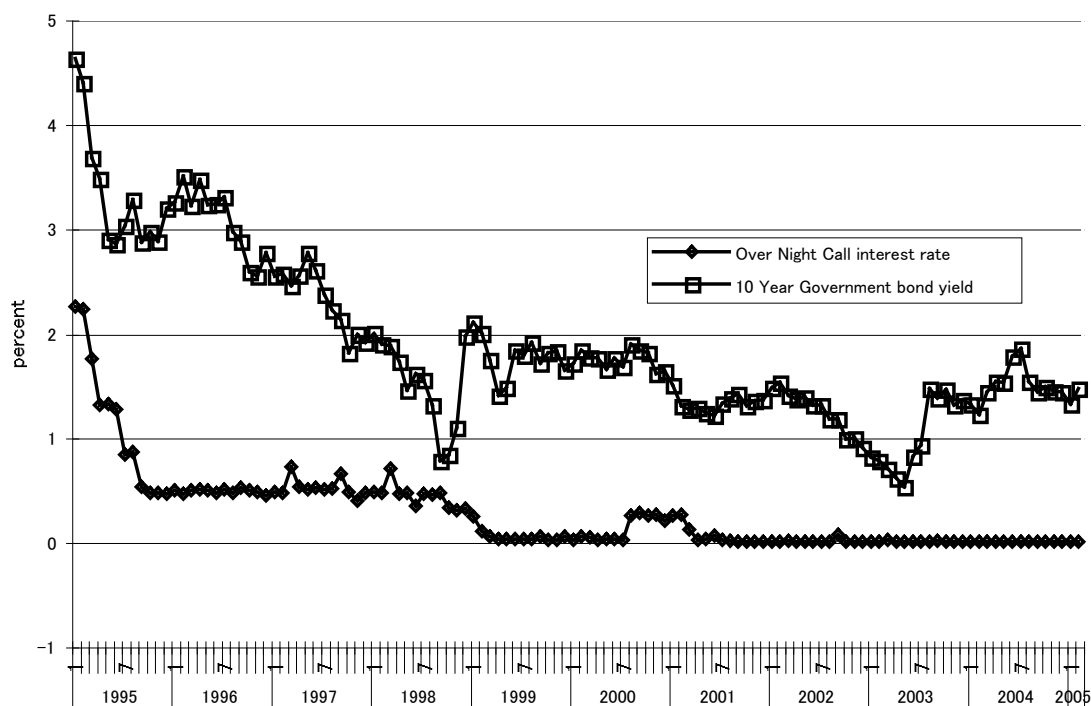
Stabilizing Government Bond Markets as an Implicit Agenda

Figure 2 shows that the interest rates of long-term government bonds have been relatively low (the prices have been high) and stable since 1999. The relationship between the budget deficit and monetary policy should be examined here. To understand the Japanese authorities' perspective on this relationship, the story starts with so-called "study group on public debt management" meetings, which the Ministry of Finance (MOF) managed between March and November 2003. At the beginning of these meetings, the economist Masaaki Honma, who is also a member of the prime minister's Council on Economic and Fiscal Policy, presented an argument based on the pessimistic scenario that long-term government bonds would fall sharply. "In case long-term government bonds' price goes down, the government could have difficulties preparing a budget and commercial banks could have damaged portfolios. How can we prepare a cushion against a possible shock? We should think of setting up a conference of both the government and the Bank of Japan."²

Honma thought that an excessive decline in prices of the long-term government bonds, even if that decline came from economic recovery, might make it difficult to prepare the government budget. To prepare for that possibility, Honma argued, the government needed a contingency plan, including the BOJ's strong support. However, Honma's agenda-setting power declined in this study group. The MOF did not want to build up feelings of crisis. For its part, the BOJ, which attended as an observer, worried about the eruption of an argument over its support. And it was a difficult topic for this study group to address.³ Honma's argument was eventually abandoned.



Figure 2. Short- and Long-term Interest Rates

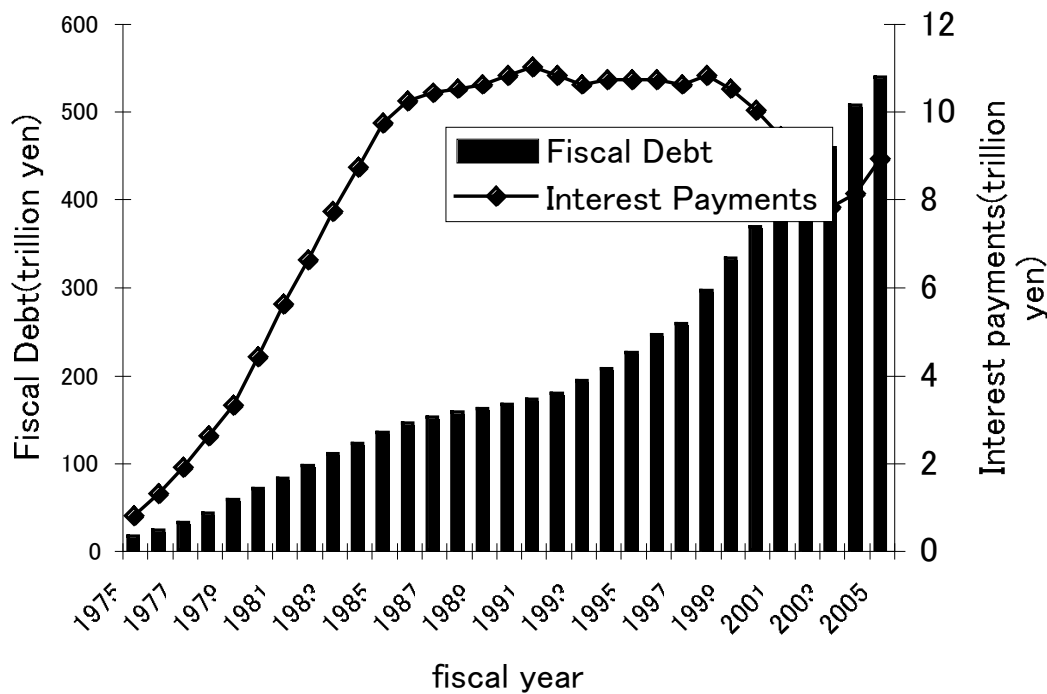


Source: Bank of Japan. See <http://www.boj.or.jp/type/stat/dlong/fin_stat/rate/cdab0722.csv> for overnight call interest rate and <http://www.boj.or.jp/type/stat/dlong/fin_stat/rate/hbmsm.csv> for 10-year government bond. Accessed April 2, 2007.

The numbers illustrating the government spending indicate the reasons for Honma's concern. By the end of fiscal year 2005, the outstanding amount of government bonds in the market will reach ¥538 trillion. It could go up to ¥638 trillion, if one includes the government investment and loan program (Zaito) bonds, which perform the same function as long-term government bonds. The ratio of central and local debt to the GDP will reach 170 percent.⁴ Potential debt is projected to increase, due to the aging population.

Surprisingly, this huge budget deficit has not necessarily an obstacle to making an annual budget, due to the decline of the government bond yield. The outstanding amount of government bonds increased significantly after 1998, when the Obuchi administration spent a large amount of tax money to boost the economy. While the accumulated debt in 2004 was twice as much as that of 1997, interest payments for this debt flattened or declined (see Figure 3). Compared with other developed countries, Japan's interest payment is disproportionately low, given the size of its debt (see Figure 4).

Figure 3. Fiscal Debt and Interest Payments of the Japanese Government

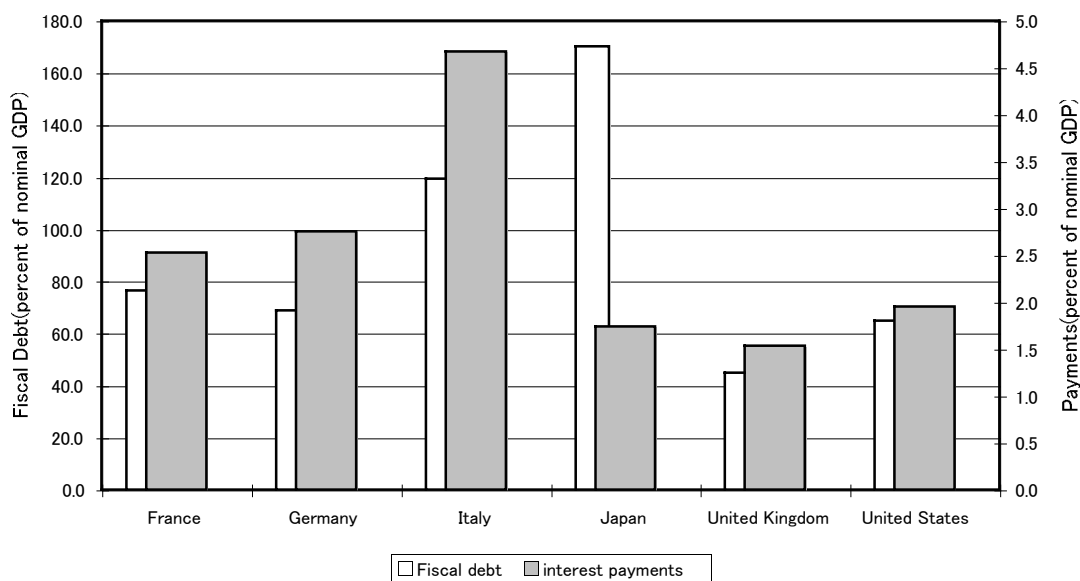


Source: Ministry of Finance.

There is a reason why Honma referred to the collaboration with the BOJ in the public debt management meetings. Government executives commonly understand that the BOJ's monetary policy contributed to the decline of long-term interest rates. In fact, the BOJ's target is not the level of long-term interest rates, but the level of short-term interest rates, or the overnight call rates. In what way has this monetary policy influenced the long-term interest rates?

What the BOJ calls the "commitment effect" is key to that question. In adopting a quantitative monetary easing policy, the BOJ decided the condition under which they would quit this monetary easing. The BOJ committed to maintain the framework for its market

Figure 4. Fiscal Debt and Net Debt Interest Payments



Source: OECD, Economic Outlook 2, no. 76. (December 2004), 197–98.



operation until the year-on-year growth of the consumer price index (excluding fresh food) became stable, at or above zero percent. During the zero percent interest rate policy from 1999 to 2000, the BOJ made a similar commitment, saying that it would maintain a zero percent interest rate policy until deflationary concerns subsided. Some politicians and economists complained that this commitment to a zero percent interest rate policy was too obscure. The BOJ accordingly revised its description of the condition under which it would cease its policy of quantitative monetary easing.

If market players predict that the quantitative monetary easing policy will last a long time, longer-term interest rates are likely to go down. It can be difficult, however, to substantiate this effect. As speculation arose that the BOJ would quit this policy, the long-term interest rates went up. Long-term interest rates rose in July and August 2003, when a rumor of the end of the quantitative money easing first circulated. Kazuo Ueda, a member of the BOJ policy board, said at a press interview, “It is thought to be natural that long-term interest rates go up and down according to the business climate, but I think this current movement is excessive. The BOJ has expected the stability of medium- and long-term interest rates by declaring that it will maintain the quantitative monetary easing until the consumer price index becomes stable at or above zero percent. In spite of that declaration, this policy ended and long-term interest rates have increased.”⁵ Toshihiko Fukui, the current BOJ governor, sought to suppress this expectation by saying “Even if the business cycle recovers, until the year-on-year growth of the consumer price index becomes stable at or above zero percent, we will maintain current monetary easing.”⁶

The other reason that monetary policy contributed to the stability of the low long-term interest rates is that the BOJ started increasing the purchase of government bonds as a tool for monetary easing. Before the quantitative monetary easing, the BOJ bought ¥400 billion worth of long-term government bonds per month. Now, it buys ¥1.4 trillion worth per month. The BOJ formerly regarded the purpose of purchasing long-term government bonds as

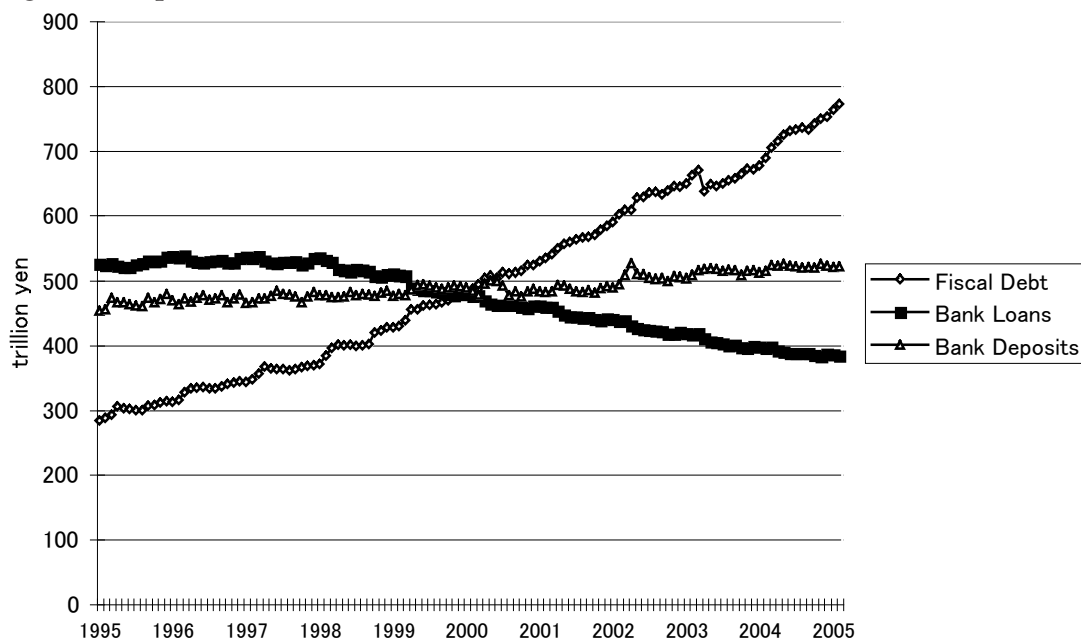
supplying money in proportion to economic growth. Given that position, increasing purchase of government bonds is quite different from conventional policy. In fact, the BOJ is buying about 40 percent of the new government bonds that the government issues.⁷

Of course, those factors cannot explain the stable long-term interest rate completely. The fact that commercial banks continued to purchase large amount of government bonds could be another important piece of the puzzle. Figure 5 shows the combined total of bank loans, government bonds, and deposits. These numbers show that deposits are poured into government bonds rather than banking loans. Commercial banks, with excessive deposits and scarce loan opportunities, were willing to buy government bonds.

In addition, we cannot ignore that the fact that the BOJ's money was a kind of seed money. When the interest rate of ten-year government bonds dipped below 0.5 percent in June 2003, a market participant's reported remarked: "The BOJ dominated government bond markets. This is not the place where traders can play their own roles."⁸ Since these market players considered the risks of government bonds to be very low due to the BOJ's existence, it is rational to follow the trend. In addressing the situation, Minister of Finance Masajuro Shiokawa noted that "government bonds have become the equivalent of money. Monetary easing is changed into government bonds."⁹

In light of the above comment, the BOJ seems to be highly involved in the management of government bonds. However, the BOJ has never declared the management of government bonds to be an objective of monetary policy. Rather, such management was part of an implicit agenda for monetary policy.

Figure 5. Deposits, Loans, and Fiscal Debt



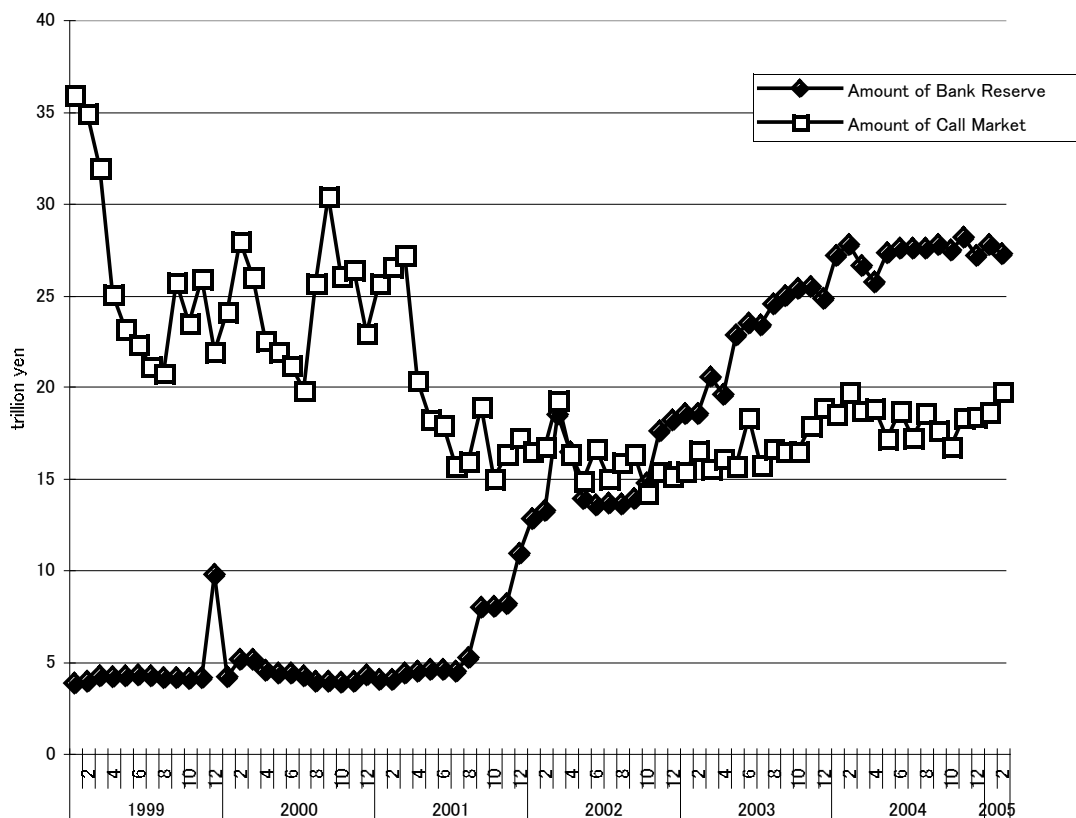
Source: Bank of Japan. See <http://www.boj.or.jp/type/stat/dlong/fin_stat/finan/cdac0100.csv> on fiscal debt; <http://www.boj.or.jp/type/stat/dlong/fin_stat/zan/ms001.csv> on bank deposits; and <http://www.boj.or.jp/type/stat/dlong/fin_stat/zan/cdab0930.csv> on bank loans. Accessed April 2, 2007.

Support for Troubled Commercial Banks and Its Consequences

While the BOJ's intervention stabilized the government bond markets, its quantitative monetary easing policy played a different role. The BOJ lent money to troubled banks through market operations, subsequently preventing financial crisis.

Figure 6 demonstrates the change of bank reserve and the change of the inter-bank market account, where commercial banks lend and borrow money to one another. The inter-bank market account declined as if it were in inverse proportion to the increase of bank reserve. This implies that the BOJ became an alternative to the inter-bank market.

Figure 6. Amount of Bank Reserve and Call Market



Source: Bank of Japan. See <http://www.boj.or.jp/type/stat/dlong/fin_stat/boj/cdab0140.csv> for bank reserves, and <http://www.boj.or.jp/type/stat/dlong/fin_stat/short/cdab0790.csv> for the call market. Accessed April 2, 2007.

Because of the zero percent interest rate policy, commercial banks with low credit had difficulty borrowing money in the inter-bank market. Extremely low interest rates meant that lenders could not gain enough interest to compensate for borrowers' risks. At the same time, the BOJ was pouring much more money than necessary into the market, which meant that banks with low credit gained as much money as they needed, directly from the BOJ.

In the Japanese financial world, regional banks tend to lend money and major banks tend to borrow money. In the middle of 2002, however, the headquarters of one regional bank

told its Tokyo branch to stop lending money to major banks whose stock prices were falling. The stocks of both Mizuho Bank and UFJ Bank were sinking because those in the financial markets believed that the new Minister for Financial Service, Heizo Takenaka, would confront commercial banks and take them to task. The regional bank's Tokyo branch had no objection to the headquarters order, and the bank ceased to lend to Mizuho and UFJ.¹⁰

Miyako Suda, a member of the BOJ policy board, pointed to the troubled banks' behavior, and remarked that, "Given the circumstances, in which financial unease was predominant, financial institutes came to gain long-term money directly from the BOJ instead of the market. To make a long story short, the function of the inter-bank market shifted to the BOJ."¹¹ Nor were these activities secret any longer. One of the officials related to monetary operation noted, "Of course regional banks have not come back to the inter-bank market. Since most of the banks deposit money in the BOJ and just hold on to it, banks that desire money cannot get enough from other banks. The truth is that instead of the market, the BOJ lends money. The BOJ's role as a money broker has been strengthened. If using a metaphor, we are increasing the amount of morphine because its efficacy has gone down."¹²

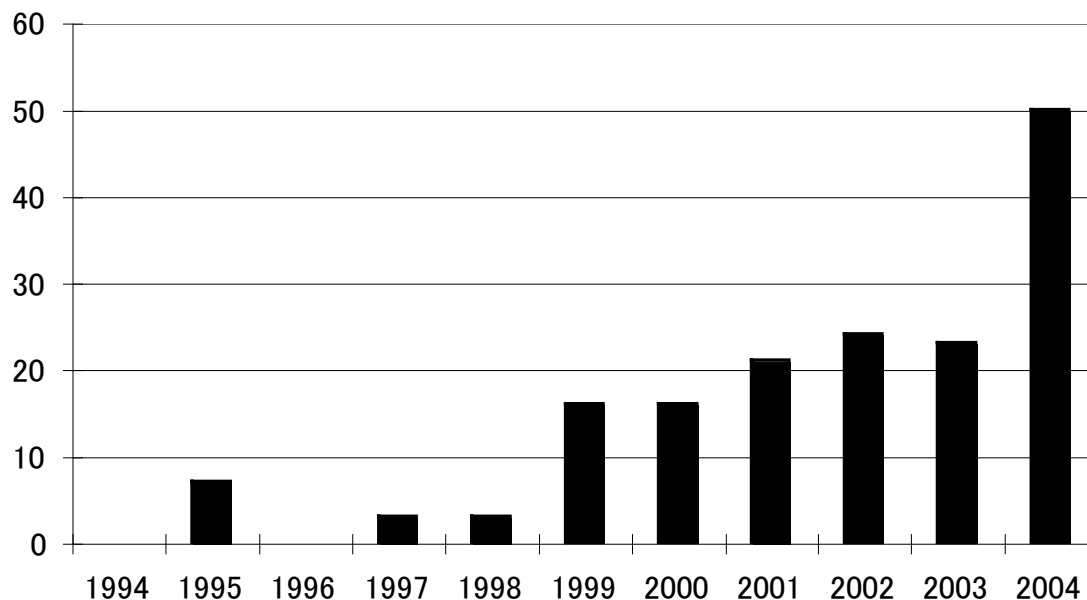
The BOJ had not started out to stabilize the financial system. Rather, former BOJ Deputy Governor Yutaka Yamaguchi said that quantitative monetary easing became a cure for the financial system, which he never expected.¹³

Banking regulation policy reinforced the supporting system. When large banks went bankrupt in the late 1990s, banking regulation was affected. For example, Hokkaido Takushoku Bank went bankrupt in 1997. Long Term Credit Bank of Japan and Nippon Credit Bank went bankrupt in 1998. In the case of Long Term Credit Bank, the government incurred a loss of ¥4 trillion. The government was then accused of selling the bank to Ripplewood Holdings, an American investment firm, for ¥1 billion.¹⁴ A BOJ official involved in the process noted that, "the government and the BOJ learned a critical lesson from the case of Long Term Credit Bank of Japan. That is, we would never allow large banks to go bankrupt."¹⁵

That lesson materialized in handling the case of Resona Bank in May 2003. The government decided to infuse capital to that bank, protecting all deposits. Crucially, the government did not require a capital asset devaluation, through which shareholders could take responsibility for the bank's failure. Therefore, through government oversight, the bank's management was meant to be reformed, even as the bank's shares were preserved. Right after the government stepped in, the stock price soared. One analyst at a security firm commented on the mood of investors, stating that, "many references came to me right after the decision to inject capital into Resona. Most of them asked me 'Which bank do you think is going to be nationalized after Resona?' They were not implying that they wanted to run away from other, less solvent banks. They were saying that they were willing to invest in them. They would be good banks to invest in, if they could enjoy similar implicit guarantees from the government."¹⁶

While the government structured its safeguards, commercial banks were expected to dispose of their nonperforming loans (NPLs) using one of two methods: bankruptcy, or debt waiver, in which commercial banks forgave part of the money lent to borrowers. In December 2001, for instance, a large construction company, Aoki Construction—deemed to be a symbol of NPLs—went bankrupt. The stock market collapsed in response. Thereafter, not surprisingly, banks shied away from large-size bankruptcies. According to Teikoku data bank, a credit information service firm in Japan, the number of debt waivers from banks began to increase in 1999 and has remained at a high level ever since (see Figure 7).

Figure 7. Numbers of Debt Waivers by Banks



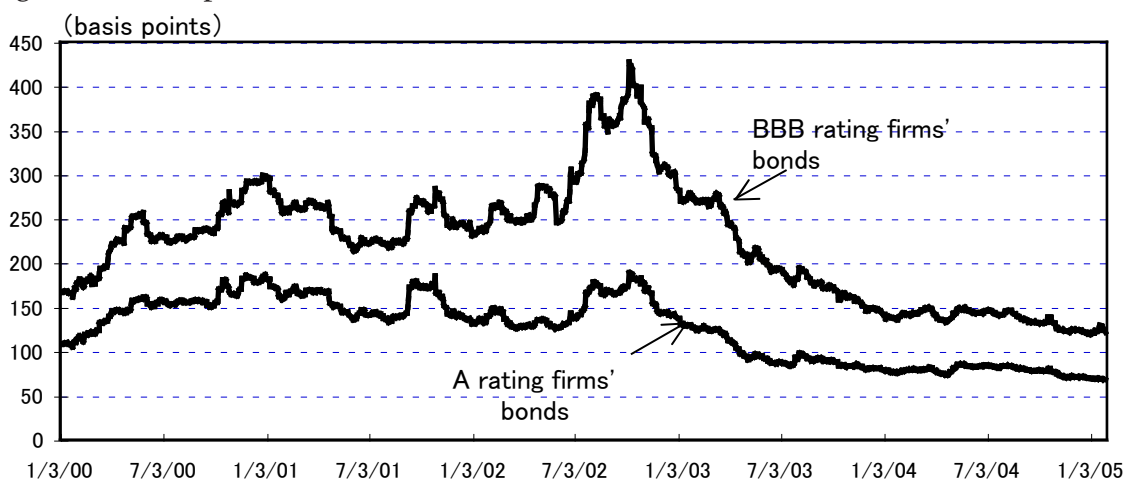
Source: Teikoku Databank. See < <http://www.tdb.co.jp/report/watching/press/pdf/p041101.pdf> > Accessed April 2, 2007.

How did these phenomena influence the Japanese financial market? In an ordinary market economy, the more debt a firm has, the greater the possibility of bankruptcy. Yet most people in the Japanese market came to think otherwise. The more debt a firm had, they believed, the more secure it was because of the increasing expectations of a debt waiver. In spring 2003, security firm dealers promoted some brands by saying, “This company is secure because it has a large amount of debt from banks.”¹⁷

Figure 8 shows the spread between corporate bonds rated “BBB” (the lowest grade of bonds except for junk bonds) and Japanese government bonds. When Mical, the nationwide retail company, went bankrupt in February 2002, the spread soared, but afterward contracted sharply, implying that large companies’ rate of default had declined significantly. The following episode in Standard & Poor’s (S&P), an international rating firm, illustrates the feelings of that period. S&P’s Tokyo office launched a new rating system in October 2003. According to this new system, even if S&P gave a company a low rating based on its financial statement, in some cases it would agree to lift that rating. Simply put, S&P gave a special dispensation to Japanese firms because of the higher likelihood of a bailout. Yet the S&P New York supervisor could not fathom such a proposal, and commented to members of the S&P Tokyo office: “I recognize what Japanese banks are trying to do, but why would they do such a thing?”¹⁸

The tendency to rescue troubled companies seems to be continuing. Mitsubishi Motors, the nationwide automobile maker, received support from the Mitsubishi Group (independently operated companies that share the Mitsubishi brand name) and from Tokyo Mitsubishi Bank in 2005. Daiei, the nation’s largest retailer, was bailed out by the Industrial Revitalization Corporation of Japan—which the government founded—in 2005.

Figure 8. Bond Spreads of A and BBB Rated Firms



Source: Nikko Citigroup.

2. Decision-making in Quantitative Monetary Easing

The Argument for Underwriting Government Bonds

How did quantitative monetary easing come about, and what factors influenced the process? It is misleading to assume that the BOJ decides its monetary policy independently of the government. It is also unrealistic to suppose that the government controls the BOJ completely. Instead, the continued conflict between the BOJ and the government has shaped the monetary policy decision-making process.

The BOJ gained independence after the new BOJ law was enacted in 1998. Under the old law, the Ministry of Finance (MOF) and the BOJ consulted each other to decide monetary policy. The new law allowed the BOJ policy board to lose its bad reputation as a sleeping board. However, they were by no means freed from political pressure. Instead, the pressure came in stages. The government became more of an explicit actor. In the period of Governor Masaru Hayami (1998–2003), the first BOJ Governor under the new BOJ law, the continuous conflict between the government and the BOJ was established.

What core agenda drove the conflict? The management of government bonds was an important but implicit component in making monetary policy, especially in debating the value of quantitative monetary easing. The BOJ was seen as one of tools for preventing fiscal crisis, and though the BOJ tried initially to reject this proposition, it loomed large over the dispute. In the end, the BOJ accepted it to compensate for the political failure of raising interest rates. During Governor Hayami's tenure, quantitative monetary easing was intended, among other objectives, to suppress a strong yen or to defeat deflation. Quantitative monetary easing was not so successful in these respects, but the BOJ's role in suppressing fiscal crisis remained pivotal. Over time, that implicit agenda became explicit.

The government depends on BOJ's engagement in managing government bonds, and this dependence constrains the BOJ and limits its independence. Although the dispute between the BOJ and the government seemed to be about policy, it is fundamentally a disagreement about

independence. The government would prefer to locate the BOJ within its larger economic policy, but the BOJ would prefer to keep a certain distance from the government.

This paper focuses on ministers and party politicians as important actors, rather than bureaucrats, who have conventionally been viewed as the more powerful of the two contingents. According to that school of thought, the MOF bureaucrats should be regarded as the main actors with respect to monetary policy. However, in the late 1990s, two important incidents made the MOF bureaucrats sluggish. The MOF was then under siege, because lavish entertainment scandals had come to light in 1997 and 1998. In those cases many MOF officials received favors from private banks or other financial firms; some were even arrested for bribery. Linked to these scandals was a large amount of government spending—under the politician-oriented Obuchi administration—which ushered in the need to manage government bonds. The preceding budget restructuring under the Ryutaro Hashimoto administration, in contrast, was strongly affected by the MOF's strategy. Finally, in summer 1998, Keizo Obuchi replaced Hashimoto and withdrew his predecessor's policy against the backdrop of economic recession.

Among the political figures, Kiichi Miyazawa (Minister of Finance, 1998–2001) is one of the most important actors. Prime Minister Obuchi appointed Miyazawa, himself a former prime minister, to bring about short-term relief, but his term ultimately lasted over two years. Miyazawa is a typical Keynesian, who believed that fiscal debt was not so troubling as long as Japanese people held on to it. Economic recovery, according to Miyazawa, could only occur via a stimulus from government spending and monetary easing; such views tended to put pressure on the BOJ.

In early 1999, another problem developed: it was argued that the BOJ should underwrite or purchase long-term government bonds. Through purchase, the BOJ buys government bonds in the market; through underwriting, the BOJ sidesteps the market entirely and buys government bonds directly from the government. This move was intended to address the rise of long-term interest rates, a fiscal policy initiated by Miyazawa. The Obuchi administration decided to spend money and cut taxes to great degree in assembling the fiscal year 1999 budget, and a huge number of government bonds were therefore expected to circulate. The trigger was the news conference that Miyazawa held on December 22, 1998. Miyazawa was asked if the Trust Fund Bureau of the MOF (Shikin Unyobu), which determines the use of funds coming from postal savings, would stop purchasing government bonds. Miyazawa answered easily, saying, “Yes, it could be true. It is not a big deal. I don't think that would be big news.”¹⁹

Right away, it became big news. Right after Miyazawa's remarks, the ten-year government bond yield, which represents long-term interest rates, surged from 1.5 percent per year to 1.7 percent. This yield continued to rise through early 1999, reaching 2.0 percent in February. The long-term interest rates problem turned out to be a pressing matter for the government. Many economists thought the problem was basically due to the budget deficit, based on the typical crowding-out theory that budget deficits cause long-term interest rates to rise and obstruct private investment.²⁰ To avoid that obstacle, some economists argued for BOJ financing. For politicians who supported the Obuchi administration, the long-term interest rate problem might have stifled its economic policy strategies.

Interestingly it was American politicians who prompted the dispute over the BOJ financing. On January 29, 1999, U.S. Treasury Secretary Robert Rubin, Deputy Treasury Secretary Larry Summers, the Japanese Liberal Democratic Party's former Secretary General Koichi

Kato, and Deputy Minister of Finance Eisuke Sakakibara, met in Davos, Switzerland. At the meeting, Summers spoke of the expectation that the BOJ would underwrite long-term government bonds.²¹ The Japanese media reported on the discussion was reported on February 4, 1999.²² Underwriting government bonds reminded the Japanese people of financing during World War II.

It is not uncommon for the U.S. government to influence Japanese policy, yet the Japanese government seemingly tried to turn this incident to its advantage. Chief Cabinet Secretary Hiromu Nonaka publicly called on the BOJ to address the long-term interest rates problem. Nonaka was another important actor, with key management and administration oversight in the Obuchi administration. At a news conference on February 8, 1999, Nonaka said that, “The BOJ, as the central bank, is responsible for overcoming economic difficulties by using several measures. In my view, it is urgent that they buy currently circulating government bonds in the market.”²³ Given BOJ law and fiscal law, it is problematic for the BOJ to underwrite government bonds directly from the government. Nonaka’s remark implied that what he really wanted was underwriting. Instead, he required the BOJ to take a more feasible measure. Nonaka was well known for using political muscle to sort out problems, and his words might have seemed like intimidation to the BOJ.

Nonaka had been critical of the MOF for a long time, so it is unlikely that the MOF bureaucrats might have manipulated him.²⁴ Rather, Nonaka’s argument about the BOJ probably represented the consensus in Obuchi administration. For Nonaka, this incident, along with the rise of long-term interest rates, was extremely serious. It might have sparked a backlash from the market against the administration’s main economic policy.

Miyazawa distanced himself from the uproar, but held fast to his expectations for BOJ support. In the Committee on Finance of the House of Representatives, Miyazawa referred to the “Twist Operation,” in which the BOJ sold short-term government bonds and bought long-term government bonds. He said, “It is time that the BOJ should think it over in order to arrange short and long term interest rates.”²⁵ Miyazawa’s remarks after the zero percent interest rate policy started illustrate his expectations.²⁶ “I realized that this was excellent management by the BOJ,” he observed. “The money, because of that extremely easy monetary policy, cannot help flowing into the government bond markets.” Miyazawa perceived that this policy could be a substitute for the purchase of long-term government bonds.

Neither Nonaka nor Miyazawa could overlook this long-term interest rate problem. Nonaka—who rose to prominence by climbing the political ladder through posts in the town assembly, as town mayor, and in the prefectural assembly—was a late bloomer as a representative. He finally succeeded as the chief of staff. He supported Prime Minister Tomiich Murayama as a minister and assisted the LDP Secretary-General Koichi Kato as a Deputy Secretary-General.²⁷ Simply put, he had to protect the Obuchi administration to guarantee his further promotion. The rising long-term interest rate was an obstacle to the administration’s economic policy. As Obuchi’s predecessor Hashimoto had recently resigned his position as the prime minister due to a deepening recession, the failure of Obuchi’s economic policy would have sounded the death knell for the administration.

Miyazawa did not have the same motivation as ordinary politicians, such as reelection and promotion. He had already held the position of prime minister and did not need to worry about re-election. He was beyond the LDP ruling retirement age, but it was taken for granted that he should be an exception. He was enjoying the position of minister of finance and its challenges motivated him. The perception that “Miyazawa is really enjoying his job”

was dominant among the MOF bureaucrats.²⁸ The experience of having resigned as prime minister against his will probably affected his feelings. Although it was believed in 1991, when he took office, that Miyazawa's administration would stand the test of time, he was forced to resign only twenty-one months later in aftermath of scandals involving the ruling party's politicians. In the Obuchi administration, Miyazawa was left utterly in charge of macroeconomic policy, and he relished the prospect.

MOF bureaucrats strongly influenced politicians, particularly on the issue of monetary easing. Moreover, the MOF had also begun to embrace a policy known as the Adjustment Inflation Policy. Though the definition of the policy was not clear, the common understanding held that the government and the central bank should cause inflation artificially. One of the officials exchanged information with the BOJ said, "Advocates of Adjustment Inflation were predominant in the MOF at that time. So when the BOJ adopted the zero percent interest rate policy, we thought that inflation would occur. In the end I realized we were wrong."²⁹

Was adjustment inflation a polished strategy? Inflation might cure the burden of fiscal debt, but it could also raise interest rates, and thereby also hurt the management of government bonds. It is doubtful that the MOF bureaucrats seriously discussed both the advantages and disadvantages. Instead, the argument of burden-sharing prevailed. Though the MOF was hurt by spending money under the Obuchi administration, the BOJ seemed to be relatively unscathed. Indeed, at that time, one MOF official said, "It looks like the BOJ is trying to clear its own yard."³¹ The MOF lost its profile as the driver of Japanese economic policy.

At this point, the issue of government bonds management apparently underlay the dispute between the government and the BOJ, but it remained implicit. Politicians' arguments focused on the influence that the rising long-term interest rate would have on private investment, namely crowding it out. This does not mean that actors did not care about fiscal crisis. For instance Miyazawa occasionally referred to the limitations of the budget. He made remarks such as, "The budget has no margin. It's like the relief ace pitcher takes the mound in the first inning."³¹ His comment that, "The budget is close to collapse,"³² plainly stated his sense of urgency. On the other hand, the BOJ began to grasp the dangerous nature of the implicit agenda and reacted against it. To be sure, in early 1999 the phrase of quantitative monetary easing was not so common. However, these disputes over the purchase of government bonds eventually enabled officials to design a prototype for quantitative easing.

The BOJ's Rejection of the Implicit Agenda

Masaru Hayami served as Governor of the BOJ from 1998 to 2003. Hayami's appointment was an unexpected consequence of the lavish entertainment scandals in which the BOJ and MOF shared infamy. Deputy Governor Toshihiko Fukui, who was expected to take the position of governor, left the BOJ, taking responsibility for his failure to oversee the personnel appropriately. The government needed to select a person free from scandal. They chose Hayami, who had left the BOJ more than fifteen years earlier and worked as an executive of a private company.

Hayami was not necessarily suited to be the BOJ Governor. He advocates a strong yen. He has little experience with monetary policy. He distances himself from the LDP. He wrote, "It is a pity that a strong yen was called something like the root of all evil and that a strong yen is regarded wrong among ordinary people as well as business people. Appreciation of the BOJ's

bill could not be bad. For Japan, which depends on imports for most of its food, fuel, and raw materials, the advantage of a strong yen cannot be overestimated.”³³ The implication of this attitude toward currency is that he strongly advocates monetary tightening. Hayami also values the BOJ’s independence. Monetary tightening has to do with the BOJ’s independence. In fact, people in the BOJ used to say, “Cutting interest rates is a loss. Hiking interest rates is a win.”³⁴ Because the government has a tendency to require monetary easing, cutting interest rates means bowing to the government. Raising interest rates means overcoming the government. This mindset is ingrained in Japan’s central bankers.

Hayami’s lack of experience in monetary policy and distance from the LDP were rooted in his professional background. The MOF and the BOJ had taken turns occupying the post of governor for a long time, which meant that a governor who climbed the BOJ ladder emerged every ten years. Candidates for governor were selected roughly in the middle of their careers. Since Hayami belonged to the same entering class as former Governor Yasushi Mieno, he was not primed for the position of governor and instead specialized in international relations, which was not mainstream relative to monetary policy. Candidates for governor were expected to nurture relationships with politicians and bureaucrats; again, this was not the case with Hayami. After retiring as the BOJ’s director, he served as CEO of a large commercial company, and as Secretary General of the Japan Association of Executives (Keizai Doyukai). He associated with opposition parties’ leaders, such as former Prime Minister Morihiro Hosokawa and former Minister Shusei Tanaka, of the Economic Planning Agency. For better or worse, Hayami was a layman leader of the BOJ. He was different from the “typical” old-type governors who had preceded him, but he came to represent a newborn Bank of Japan.

Compared to Miyazawa, Hayami did not exercise much leadership. BOJ administrators should be regarded as actors, in the center of which stood Deputy Governor Yutaka Yamaguchi. To be sure, Hayami and BOJ administrators were sometimes in conflict and it was accepted that members of policy boards who were elected from various backgrounds were no longer rubber stamps. Yet the important thing is that there was a common ground among executives and administrators—all aspired to protect and promote the independence of the central bank. The supposition here is that the BOJ decision-making process was based both on maintaining its independence and on judging and managing the economy.

The implicit agenda of government bonds management might have undermined the BOJ’s independence. With respect to underwriting government bonds, there was broad consensus in the BOJ that they should repel such demands. Hayami addressed the Diet: “Underwriting cannot be an option that the BOJ adopts. Even if people hate the BOJ, we will do what we believe is right.”³⁵ The BOJ purchased some government bonds on daily basis, but according to the BOJ’s theory, these purchases were intended not for monetary easing, but to provide the market with an amount of money proportional to economic growth. If the BOJ increased its purchases, that action would have been equivalent to underwriting.

The BOJ disliked the underwriting and purchasing of long-term government bonds. Kunio Okina, one of the BOJ economists, criticized underwriting, citing the historical fact that the Weimar Republic suffered from hyperinflation. He noted:

The absorption of government bonds by the BOJ would be akin to introducing a (illegal) drug into the economy. [I]f the government came to accept such indulgence there is a

very real risk that it would be difficult to end . . . because it would be too painful, as is evidenced by historical experience, and might impair the national interest of Japan from a long-term perspective. In this context, it is noteworthy that there are some who, in the view of recent accumulation of fiscal deficit, predict that Japan might follow the same path as the Weimar Republic, whose massive budget deficit was monetized by the central bank's underwriting of government bonds, only resulting in economic crisis with hyperinflation, capital flight and a GDP decline.³⁶

But the BOJ administrators realized the strength of the political pressure. The administrators started leaning toward the idea that they should adopt additional, stronger measures to counter politicians' criticisms. They decided on the zero percent interest rate policy, which had been under consideration since the BOJ cut interest rates to 0.25 percent.³⁷ At a monetary policy meeting on February 12, 1999, the BOJ decided not to purchase government bonds, but instead to cut the short-term interest rate from 0.25 percent per year to 0.15 percent. On March 3, they declared beginning of the zero percent interest rate policy. This policy caused some frustration—which Hayami shared—in the BOJ, and such feelings about the zero interest rate, mixed with aspirations for independence, played an important role in the subsequent lifting of the zero interest rate policy.

Does increasing the long-term interest rate make it subject to crowding-out theory, a theory described in economics textbooks? According to “crowding-out theory,” government purchases edge out investment through rising interest rates.³⁸ The question is controversial. Given that the Japanese economic recovery is the result of government spending, it is possible, on the one hand, to think that increasing the long-term interest rates was just a sign of economic recovery. On the other hand, in a political context, raising interest rates could be explained as an unpleasant phenomenon caused by the budget deficit. It became common knowledge that the BOJ had eased that fiscal constraint through monetary policy. Economics and politics aside, however, the key point is that politicians widely recognized that the market could be suppressed by means of monetary policy.

Miyazawa's Shift to Quantitative Monetary Easing and the Threat of the Strong Yen

After the zero interest rate policy began, the argument for further monetary easing emerged in the form of the phrase “quantitative monetary easing.” The general definition of this kind of easing is that the central bank should supply money beyond necessity. Quantitative monetary easing can be conducted in several ways, including the purchase of government bonds. Until fall 1999, the mainstream argument involved so-called sterilization. A sterilization scenario occurs when the central bank lifts money from the inter-bank market after the government—in an effort to intervene in the foreign exchange market—has put money in. Opponents of this practice claimed that the BOJ should stop sterilization and leave money in the market.

Minister of Finance Miyazawa was at first uncomfortable about these arguments. As a traditional Keynesian, he did not believe that such monetary easing was meaningful. He asked, “Where is the shortage of money? Where is the bottleneck of money?”³⁹ But Miyazawa's way of thinking did not last. He began to accept quantitative easing in September 1999. Without warning, he invited the BOJ Governor Hayami to discuss monetary policy at a hotel located

between the MOF and the BOJ. Though their precise conversation remains unknown, right after that meeting Miyazawa began talking publicly about the expectation of further monetary easing, and it seems fair to assume that the meeting focused on monetary easing.⁴⁰

What made Miyazawa change his mind? The key to the puzzle is the strong yen. Miyazawa had also held the position of Minister of Finance in the 1980s. The yen strengthened under his tenure, and according to MOF officials, that experience made Miyazawa resistant to a strong yen. But in 1999, a strong yen was again beginning to emerge. The speculation that economic growth during the first quarter of 1999 would be better than expected was leaked in early June 1999, an event that could in itself bring about a strong yen. Miyazawa and Deputy Minister Eisuke Sakakibara talked preparing for the strong yen and concluded that the government should intervene decisively in the market. In order to make that intervention more effective, they needed cooperation from the United States. Judicious intervention in the foreign exchange market was their optimal strategy, but the bottom line was that the United States would have to demonstrate a cooperative attitude at an international conference, such as the Group of Seven (G7) meeting. However, the United States felt that Japan still had much of its own quantitative monetary easing to do before it could request or rely on U.S. involvement. By September, Miyazawa realized that the United States required further monetary easing, and this development affected his own perspective.⁴¹

Some reports say that Miyazawa persuaded the normally stubborn Hayami, who asked administrators to consider further monetary easing by saying, "I have been associated with Miyazawa for a long time." Despite Hayami's encouragement, MOF administrators ultimately declined to increase monetary easing, on the grounds that it is not appropriate for the BOJ to change its policy simply because the government requests it.⁴²

After this incident, Hayami seems to have returned to his customary stubbornness. Indeed, in September 1999, Miyazawa and Hayami attended a G7 meeting in Washington, DC. The MOF was still eager to make a G7 statement expressing concern about a strong yen. To do so, the United States and Japan made a hidden deal. In exchange for the BOJ referring to the likelihood of easing monetary policy, the United States would agree with the concern about a strong yen. However, in a top-level meeting, where Miyazawa, Hayami, Treasury Secretary Larry Summers and Federal Reserve Chairman Alan Greenspan were, Hayami unexpectedly changed tack and started supporting a strong yen instead of talking about easing monetary policy. This about-face violated the U.S.-Japan deal, and Summers lost his temper. Miyazawa again negotiated with Summers in a separate room, and, it seemed, brought Hayami back into line. But Hayami made similar remarks denying the need for further monetary easing at a later news conference, and provoked the Treasury again. U.S. Treasury officials blamed the BOJ officials for Hayami's behavior, citing Japanese newspapers that reported Hayami's remarks. In the end, Hayami called another press conference to modify his previous remarks.⁴³

Lifting the Zero Interest Rate Policy Based on the Aspiration for Independence

In summer 2000, the BOJ raised the short-term interest rate by 0.25 percent, in defiance of the government's request that the current policy be maintained through August. This action was regarded not only as a response to the business cycle, but also an indication of the BOJ's independence. The government, noticing the BOJ's intent in advance, tried to stop it,

or at least to postpone it. Lifting the zero interest rate policy would have strengthened the BOJ's independence; keeping the policy would have jeopardized that independence. The BOJ eventually rejected the government's demand.

Some reports say that Hayami led the move to lift the zero interest rate policy. In the House of Councilors committee, on August 7, 2000, he memorably noted that, "I think concern for deflation was swept away according to statistics on the real economy that I am watching." It was time, in other words, to lift the zero interest rate. Though Deputy Governor Yamaguchi wavered in his judgment on the issue, Hayami—who seemed obsessed with the BOJ's independence—provided an impetus for the decision.⁴⁴ Right after the policy meeting, Hayami told reports "We thought that the BOJ should show independence and autonomy in operating in the currency and financial markets. That's why we decided on this policy."⁴⁵ To many onlookers, this turmoil was a straightforward show of independence. "The important thing is whether or not the BOJ's has real independence as written in the law," noted one scholar. "We cannot emphasize too much the fact that the BOJ acted on its own, in spite of political pressure."⁴⁶

Acceptance of Quantitative Monetary Easing in the Aftermath of Political Failure

Despite the BOJ's exaltation in its newfound independence, this decision to lift the zero interest rate policy was actually a political failure. The period of economic expansion ended shortly thereafter (it had peaked in November 2000); indeed, the business cycle began to decline three months after the BOJ raised interest rates.

With the business climate deteriorating, the BOJ came under fire and moved toward monetary easing. The BOJ cut the discount rate from 0.5 percent to 0.35 percent in February 9, 2000 and cut overnight call rate from 0.25 percent to 0.15 percent on February 28, 2000. Nothing helped. What to do next? On February 9, members of the Policy Board had argued in their monetary policy meeting that, "The political pressure on us is getting harsher. We should do something or we will plunge into a more difficult situation.... We should put aside the past incident and give consideration to real economic change."⁴⁷ In the monetary policy meeting on February 28, a member observed that, "If we wait and see, we will be regarded unresponsive to the business cycle."⁴⁸ The BOJ agonized over how to act at the next stage.

The BOJ Policy Board had two options: a return to a zero interest rate policy, or begin quantitative monetary easing. The former seemed more consistent with past policy. Even Deputy Governor Yutaka Yamaguchi, who was a figurehead in these kinds of discussions, advocated the zero interest rate policy. Yet surprisingly, Hayami supported quantitative monetary easing. Quantitative monetary easing was thought to be a more intensive measure than a zero interest rate policy, and the purchase of long-term government bonds was a prerequisite for quantitative monetary easing.⁴⁹

Given that Hayami once rejected the purchase of government bonds, his support for quantitative easing was improbable. Why did he change his mind? One supposition is that Hayami might have wanted to avoid being responsible for misjudgment. Politically, the BOJ faced a dilemma. A simple return to zero interest rates might have meant the BOJ conceding the failure of lifting its zero interest rate policy. In the case of a new policy, in this case quantitative monetary easing, the BOJ could justify the conversion by explaining

it as an adjustment to new economic circumstances. Hayami denied misjudgment at a press conference after the monetary policy meeting. “I do not think I made a mistake,” he noted. “This monetary easing came from the changes that took place six months after getting out of the zero interest rate policy.”⁵⁰

The new quantitative monetary easing policy posed some difficulties, notably how to provide money. To handle this problem, the purchase of government bonds—which the BOJ had vigorously rejected—became technically inevitable. In addition, reflecting the view that lifting the zero interest rate policy had betrayed market expectations, the BOJ further swallowed its pride and promised to keep to the new policy until year-on-year growth of the consumer price index became stable at or above zero percent.⁵¹ Both actions eventually contributed to the stable long-term interest rates described earlier in this paper.

Hayami and Miyazawa talked on the phone three days before the monetary policy meeting. Hayami said that he was prepared to institute further monetary easing, saying, “I would behave as you expected, though I cannot elaborate on the decision yet.”⁵² It was at this moment that the stepped into uncharted territory: it accepted the hidden agenda of government bonds management, having first refused it in 1999.

Political Pressure and Power Shift—From Cabinet to Ruling Party

In the government’s economic policy decision-making process, the shift from cabinet to party politicians was under way. Kiro Mori had become prime minister after Obuchi was hospitalized in April 2000. One of the most important actors in the Mori administration was Shizuka Kamei, chairman of the LDP Policy Research Council. Unlike Obuchi, who had counted on Miyazawa to help form economic policy, Mori left most of the policy to Kamei. Kamei is not a true Keynesian, but his standpoint was that of a Keynesian politician. He did not believe that market adjustments function well, but he did believe in the role of the government. Kamei said, “Of course socialism collapsed, nonetheless it is not ideal that the market decides everything and the strong prey on the weak. It is unrealistic to lift regulations that are intended to protect the weak and to do anything for money-making.”⁵³ Kamei was a major player in postponing the payoff system (which limits refunds in banking bankruptcy) in April 2001 and he strongly advocated budget expansion. Simply put, he could be called a typical LDP politician. With respect to monetary policy, it was natural that he advocated quantitative easing. Kamei said to one BOJ official in March 2001, “I realize you are struggling, but I would ask you to do quantitative monetary easing. Please consider that.”⁵⁴

Another notable LDP claim was that the government should amend the Bank of Japan Law to make the BOJ less independent. For instance, in February 2001, a meeting of the Treasury and Finance Division under the Policy Research Council decided to set up a project team to study the BOJ law. One of the meeting attendees shared a private draft of an amendment to the law, which stipulated that the BOJ would postpone a decision if the government requested it.⁵⁵ Hideyuki Aizawa and Kozo Yamamoto, both former MOF bureaucrats, played major roles in this movement. They made several drafts of the amendment and finally they asserted that the prime minister should have power to fire the BOJ governor, though this argument was never made a bill. It is not clear how much influence Aizawa and Yamamoto had over the BOJ’s decision, but their activities certainly made BOJ officials nervous.

The political pressure on the BOJ became stark during the power shifts from the cabinet to ruling party politicians. As politicians outside of the cabinet, ruling party politicians often felt free to blame the BOJ. The BOJ's political failure to lift the zero interest rate policy only intensified the blame and the pressure. It was under these circumstances that the BOJ decided to move into uncharted waters: quantitative monetary easing.

Management of Government Bonds

Minister of Finance Miyazawa left the administration as Junichiro Koizumi took office as prime minister in 2001. How did the MOF executives' attitudes toward the BOJ change? The short answer is that they were emboldened to request the purchase of government bonds. The most notable example of this new boldness is that Miyazawa's successor, Minister of Finance Masajuro Shiokawa, said at a February 26, 2002 press conference that he wanted the BOJ to increase the purchase of government bonds from ¥800 billion to ¥1 trillion. It was a rare case of the Minister of Finance making an obvious request to the BOJ. The MOF's behavior—as if to scrounge money from the central bank—might have prompted speculation that fiscal discipline would loosen, or that the bond markets would be harmed. Miyazawa therefore chose his words cautiously when he spoke in public about monetary policy. Then, the climate changed, and the authorities concerned dropped their intention to modify their request.

Deputy Minister of Finance Takayoshi Taniguchi, who attended the monetary policy meeting as a representative of the government, took a perennial approach, asking the BOJ to increase its purchases. His approach continued from December 2002 to March 2003.⁵⁶ Further monetary easing, he argued, was necessary to overcome deflation. However, an official of the BOJ, involved in exchanging information with the MOF said, “The MOF people want the BOJ to continue to buy government bonds even if the BOJ comes back to ordinary monetary policy.”⁵⁷ The explicit agenda of government bonds management seems to have grown steadily.

And what of Hayami's attitude? Surprisingly, he came to harmonize with the government. This change was associated with the turmoil over his resignation. From March to April 2001, Miyazawa and Hayami plotted to replace the BOJ governor. They sought to have Hayami resign in the middle of his term, and for former Deputy Governor Toshihiko Fukui to replace him. For his part, Hayami wanted to resign because of the considerable political friction he was facing. The presidential election in the LDP, which would decide the next Prime Minister, had been planned for April. Ryutaro Hashimoto, the leader of the largest faction, was expected to win. Criticism against Hayami was strong especially in the Hashimoto faction. Hashimoto's win would mean that Hayami would be exposed to even harsher criticism.

Hayami's intention to resign, which was reported in late April, became big news. But by then the circumstances had changed. Junichiro Koizumi was elected as the LDP President, contrary to general expectations. Koizumi was a maverick in the LDP. He had participated in a study group with opposition party leaders such as Morihiro Hosokawa and Shuusei Tanaka. Hayami, as the general secretary of Japan Association of Corporate Executives, was also among the members. Indeed, Hayami and Koizumi seemed to share the goal of structural reform. All at once, Hayami lost his reason to resign, and the Koizumi administration did not have time, in the first flush of its victory to select a new Governor of the BOJ. The plot that Miyazawa and Hayami made was sealed.⁵⁸

This turmoil affected Hayami in two ways and contributed to his subsequent weakness. First, he warmed to the administration because of his sympathy with Koizumi. Second, he made his situation worse by abandoning his plan to resign. Hayami began to lean on the government. The BOJ, asked to increase the purchase of government bonds by Minister of Finance Shiokawa, accepted this request completely in the monetary policy meeting on February 28. Hayami said at a press conference that day, I think it is good that we decided to ease monetary policy so that we can keep step with the government that is now searching for ways to fight deflation.”⁵⁹ On October 30, at another press conference announcing further monetary easing by the BOJ, he said, “We decided on policy in harmony with the government.”⁶⁰ Of course Hayami’s attitude did not determine every policy, yet it is apparent that the strain between the government and the BOJ had slackened. It was this key circumstance that emboldened the MOF executives to ask for the purchase of government bonds.

Another notable event during this period was the movement in the bond markets. At the beginning of the argument over quantitative monetary easing, there was strong opposition to this policy. That is, if the government appeared to be scrounging money from the central bank, government bonds could lose trust because the market might doubt the government’s fiscal discipline. This argument occurred not only among economists but also in popular novels and media. For instance, a mystery story, which describes Japan’s bankruptcy coming from a huge amount of fiscal debt, became a bestseller.⁶¹ In the end, these speculations did not come true. Even though an international rating firm lowered the rating of Japan’s government to that of an emerging country in 2002, the price of government bonds continued to be relatively stable. Against this backdrop, politicians were able to demand purchase of government bonds of the BOJ without worrying about the market backlash.

The agenda of government bonds management is no longer implicit. One opposition party politician pointed out that the biggest purpose of quantitative easing had changed government bonds management from a support for the economy, and not merely a stimulus.⁶²

Quantitative monetary easing did not have a positive effect on either the strong yen or deflation.⁶³ Did the BOJ concede that its monetary policy had no meaning? Not necessarily. It is interesting to note that one unexpected effect—that of preventing a financial crisis—helped the BOJ to justify this policy. For instance, BOJ Deputy Governor Yamaguchi said, “Quantitative monetary easing is not meaningless. It wiped out the financial confusion in the inter-bank markets, and became pivotal in stabilizing the financial system.”⁶⁴ While the BOJ emphasizes this unexpected effect, the implicit agenda has been a major policy point for the government. Such behind-the-scenes collusion between the BOJ and the government, now rooted in recent past practice, is apparently continuing.

Looking back on this turbulent period in Japanese fiscal policy, it is difficult to judge the winner and the loser. Politicians who managed the various administrations might be winners. For the Obuchi administration, monetary easing prevented the government debt problem from becoming an obstacle. For the Koizumi administration, monetary easing functioned as a painkiller for structural reform. Bureaucrats in the MOF and the BOJ, by contrast, might be considered half-winners and half-losers, though such simplistic designations do not adequately describe these complex issues. For the MOF, strong monetary easing is a double-edged sword: fiscal crisis did not happen, but the MOF lost a tool to recognize it in the first place. For the BOJ, its balance sheet was expanded and damaged, but it somehow kept its independence.

3. Conclusion: Separating Monetary Policy from the Management of Government Bonds

This paper suggests that quantitative monetary easing stems from accumulating fiscal debt. Quantitative monetary easing has likewise helped to suppress the side effects of such debt by reducing the functions of the interest rate. In metaphorical terms, the BOJ and the government placed the Japanese economy in a sterile room during the period covered by this paper. This room served to prevent both fiscal and financial crisis. It is possible to assume that these efficacies also contributed to low unemployment rates. But today, the situation is growing more complex. First, while commercial banks progress in disposing of their nonperforming loans, the need to prevent financial crisis decreases. Second, amid economic recovery, the function of the interest rate is needed to allocate resources efficiently. Third, in spite of the previous two changes, the problem of government bonds management is actually growing more serious.

Motoshige Ito warns of the hidden risks in Japan's deficit and aging population problems. Ito states that Japan now confronts two difficulties. While it has the potential to accumulate a large deficit to care for its aging society, it already has one of the world's biggest budget deficits. If the government raises taxes to make up the deficit, the Japanese economy itself could face difficulties. Ito further points out that low interest rates amid long lasting deflation are increasing the risk of fiscal crisis.⁶⁵

Policymakers will face a dilemma as economic recovery progresses. The BOJ will need to raise interest rates, but such a normalization could harm the management of government bonds. For instance, one MOF officials said, "the Japanese budget system could not be sustainable without deflation."⁶⁶ The effort to separate interest rate functions from government bonds management is therefore critical.

Reviving the function of interest rates is essential for normalization. However, many doubt the timing of such a policy. Is the Japanese economy so strong that interest rates can safely be raised? Will monetary tightening stifle the Japanese economy that is only just now recovering? One scholar, Makoto Saito, was one of few to support raising interest rates at an early stage. According to his argument, super low rates might have caused strong money demand and weak commodity demand, subsequently allured deflation. His argument shows two measures overcome deflation. One is to scatter money so that the supply exceeds the demand. The other is to reduce money demand by raising interest rates. Saito supported the latter measure.⁶⁷ Nowadays, it is widely expected that demands for the proper functioning of interest rates will gain support during economic recovery.

Complete or Partial Separation?

How, then, to deal with government bonds? There could be two scenarios, one less optimal than the other. The optimal option is to divide government bonds management from monetary policy completely. In doing so, it is vital that the government show the market consistent discipline about budgetary policy. Handling the welfare program payments which are expected to accumulate in the future will be crucial to this strategy, as will the expansion of investors,

especially foreign ones. Though the MOF has proclaimed measures to prompt foreign investment in government bonds, the real intention is the reverse—the hope that domestic investment will guarantee stable bond markets. The MOF has recently been changing its view, however, as evidenced by its support of this plan in overseas publicity.

The less optimal option is to continue with the BOJ's involvement. This is probably an acrobatic measure, since the BOJ continues to buy government bonds even in the face of rising interest rates. Hideo Kumano, an economist with Dai-ichi Life Research Institute, points to this possibility.⁶⁸ One former BOJ executive notes that the BOJ's lending to the government could also be an option.⁶⁹ This measure could make it possible to revive the function of interest rates but likewise means that the BOJ will engage entirely in government bonds management. Such activities should be justified if fiscal crisis looms.

It is important to avoid the worst-case scenario, in which fiscal crisis causes capital flight and hyperinflation. Keiichiro Kobayashi explains that has not happened so far because of a strong yen, and a correspondingly healthy trade surplus, and Japanese people's hesitancy to shift their property into foreign currency despite of zero interest rates. Kobayashi says, "In several years (or ten years) the exhaustion of the account surplus could lead to the expectation that the yen is likely to decline. If some incident triggers abrupt capital flight, the collapse of government bonds, an extremely weak yen, and hyperinflation could come out. That would be a crisis such as one might see in a developing country."⁷⁰

Japan has limited time to solve the problem.

Notes

1. Masaya Sakuragawa, *Kinyu Rikkoku Ron* (Essay of Financial Nation). (Tokyo: Kobunsha, 2005), 120–21.
2. Author's interview with Masakaki Honma, February 9, 2004.
3. Author's interview with Honma, February 9, 2004.
4. The U.S. ratio is 64 percent; the German ratio is 68 percent, and the UK ratio is 44 percent (*OECD Economic Outlook* issue 2, no. 76 (December 2004), 197–98.
5. *Asahi Shimbun*, "Interview with Ueda," September 2, 2003, 11.
6. *Asahi Shimbun*, "A Press Conference by Fukui," September 4, 2003, 3.
7. Miyako Suda, "Quantitative Monetary Easing," speech delivered December 17, 2003, <<http://www.boj.or.jp/type/press/koen/ko0312d.htm>> Accessed April 2, 2007.
8. *Asahi Shimbun*, "Bond Market Does Not Care about Risks," June 14, 2003, 11.
9. *Nihon Keizai Shimbun*, "Shiokawa is Concerned that Money from the BOJ Goes to the Government Bonds," July 7, 2004, 3.
10. Author's interview with regional bank official, December 2002.
11. Suda, "Quantitative Monetary Easing."
12. Author's interview with BOJ official, June 5, 2003.
13. Naoaki Okabe, "The Last Fight against Deflation," *Nohon Keizai Shimbun*, March 28, 2005, 5.
14. See Toru Sakurai, "Shinsei Bank, Success or Failure?" *Asahi Shimbun*, November 5, 2001, 7; and Sakurai, "Tuition Fee Was Expensive," *Asahi Shimbun*, February 20, 2004, 2.
15. Author's interview with BOJ official, March 12, 2003.
16. Author's interview with security firm analyst, September 26, 2003.
17. *Asahi Shimbun*, "Bond Market Does Not Care about Risks," June 14, 2003, 11.

18. Author's interview with Standard & Poor's official, Tokyo office, September 25, 2003.
19. See <<http://www.mof.go.jp/kaiken/kaiken.htm>> Accessed April 2, 2007.
20. For example, see a report from "Study Group about Change in Money Flow toward the 21st Century," July 9, 1999, 8–9; and Ryutaro Kono, "Strengthen Budget Policy," *Nikkei Kinyu Shimbun*, April 7, 1999 <<http://www.mof.go.jp/singikai/henkaku/top.htm>> Accessed April 2, 2007.
21. Summers' argument, it seems, was based on the views of mainstream U.S. economists. For instance, Ben Bernanke suggested that the BOJ consider nonstandard open-market operation, such as purchasing long-term government bonds or corporate bonds. See Ben Bernanke, "Japanese Monetary Policy: A Case of Self-Induced Paralysis?" 1999, <<http://www.princeton.edu/~svensson/und/522/Readings/Bernanke.pdf>> 23–24. Accessed April 2, 2007.
22. Kato recalled Summers' remarks at the Davos meeting as follows: "Japan is making efforts, but how about the discussion of the BOJ's underwriting of government bonds?" I felt strange and answered, "Few politicians are arguing about it but I think the government will refuse it." Author's interview with Kato, February 10, 1999.
23. *Asahi Shimbun* (evening edn), "Nonaka Wants the BOJ to Buy the Government Bonds," February 8, 1999.
24. Hiromu Nonaka, *Watashi wa Tatakau* (I Will Fight) (Tokyo: Kodansha, 1996), 145–67.
25. *Nihon Keizai Shimbun*, "Financial Minister Wants the BOJ to Consider Twist Operation," February 6, 1999.
26. Author's interview with Kiichi Miyazawa, March 4, 1999.
27. Nonaka, *Watashi wa Tatakau*, 123–43, 192–94.
28. Author's interview with MOF official, June 16, 1999.
29. Author's interview with MOF official, August 28, 2001.
30. Author's interview with MOF official, February 8, 1999.
31. News conference, December 21, <<http://www.mof.go.jp/kaiken/kaiken.htm>> Accessed April 2, 2007.
32. Kiichi Miyazawa, remarks in Committee on Budget, House of Councilors (March 8, 2001) reported in *Asahi Shimbun* (evening edn), "Tokyo Foreign Exchange Market, 1 Dollar is 120 Yen," March 8, 2001.
33. Masaru Hayami, *Yen ga Sonkeisareru Hi* (The Day When Yen Will Be Respected), (Tokyo: Toyokeizaishinposha, 1995), 133–37.
34. Author's interview with BOJ official, October 27, 2003.
35. Kensuke Karube, *Zero Kinri* (Zero Interest Rates), (Tokyo: Iwanami Shoten, 2004), 75.
36. Kunio Okina, "Rejoinder to Comments Made by Professors McKinnon and Meltzer," Discussion Paper for Monetary and Economic Study, Bank of Japan (December 1999) <<http://www.imes.boj.or.jp/japanese/all99/abst/me17-3-6.html>> 193. Accessed April 2, 2007.
37. Karube, *Zero Kinri*, 85.
38. John Taylor, *Economics* (4th edn), (New York: Houghton Mifflin, 2004), 492–95.
39. Author's interview with Kiichi Miyazawa, September 9, 1999.
40. Author's interview with Kiichi Miyazawa, September 18, 1999.
41. Author's interview with Kiichi Miyazawa, September 16, 1999.
42. Karube, *Zero Kinri*, 123–28.
43. Author's interview with MOF official, September 26, 1999.
44. *Nihon Keizai Shimbun*, "Document toward Lifting Zero Interest Rates," August 12, 2000, 3.

45. See the BOJ website <<http://www.boj.or.jp/type/press/kaiken/kk0008a.htm>> Accessed April 2, 2007.

46. Kentaro Fukumoto, "Lifting Zero Interest Rates Shows the BOJ's Independence," *Asahi Shimbun*, August 24, 2000, 11.

47. Yasuyuki Nishii and Toru Sakurai, "Anxiety about Decision of Zero Interest Rates," *Asahi Shimbun*, April 19, 2001, 12.

48. Nishii and Sakurai, "Anxiety about Decision of Zero Interest Rates."

49. Author's interview with BOJ official, May 14, 2001.

50. See the BOJ website <<http://www.boj.or.jp/type/press/kaiken/kk0103b.htm>> Accessed April 2, 2007.

51. The economist Ryutaro Komiya speculated about this decision, noting that, "probably that's because they might have been ashamed to return to zero interest rates." See Komiya, *Kinyuseisaku Rongi no Soten* (Controversies of Monetary Policy Issues), (Tokyo: Nihon Keizai Shimbunsha, 2002), 266.

52. Personal communication, March 16, 2001.

53. Author's interview with Shizuka Kamei, chairman of the Liberal Democratic Party Policy Research Council, May 26, 2000.

54. Nishii and Sakurai, "Anxiety about Decision of Zero Interest Rates."

55. *Asahi Shimbun*, "The Liberal Democratic Party Complains about the BOJ's Monetary Policy," February 15, 2001.

56. Minutes of Monetary Policy Meeting held January 21–22, 2003 <<http://www.boj.or.jp/type/release/teiki/giji/g030122.htm>> Accessed April 2, 2007.

57. Author's interview with BOJ official, November 2002.

58. Author's interview with MOF official, May 11, 2001.

59. See <<http://www.boj.or.jp/type/press/kaiken/kk0203a.htm>> Accessed April 2, 2007.

60. See <<http://www.boj.or.jp/type/press/kaiken/kk0210d.htm>> Accessed April 2, 2007.

61. Main Koda, *Nihon Kokusai* (Japanese Government Bonds), vols. 1 and 2 (Tokyo: Kodansha, 2000), 242–52 (vol. 1), 6–22 (vol. 2).

62. Tetsushi Takahashi "Honeymoon between the Government and the BOJ," *Nikkei Kinyu Shimbun*, October 22, 2004.

63. With respect to the relationship between interest rates and exchange rate, some scholars argues that a strong yen causes low interest rates. Ronald McKinnon remarks that Japan's interest rates have been forced to zero by the pressure for yen appreciation. He doubts, therefore, that Japan's monetary policy can affect foreign exchange rates. See McKinnon, "Comments on 'Monetary Policy under Zero Inflation,'" Institute for Monetary and Economic Studies, Bank of Japan, (December 1999) <<http://www.imes.boj.or.jp/japanese/all99/abst/me17-3-6.html>> 183–88, Accessed on April 2, 2007; and Rishi Goyal and Ronald McKinnon, "Japan's Negative Risk Premium in Interest Rates: The Liquidity Trap and Fall in Bank Lending," discussion paper for Institute for Monetary and Economic Studies, Bank of Japan (June 2002) <http://www.imes.boj.or.jp/english/publication/edps/fedps2002_index.html> 2–10, Accessed April 2, 2007.

64. Tetsufumi Arita, "Interview: Yutaka Yamaguchi," *Asahi Shimbun*, January 24, 2003.

65. Motoshige Ito, "Nihonkeizaihukkatsu no Kagi wo Nigiru Kotekibumon" (Public Sector: The Key to Japan's Economic Revival), *Chuo Koron* (October 2004), 170–78.

66. Author's interview with MOF official, January 16, 2004.

67. Makoto Saito, "Sakkon no Kinyu seisaku ni tuite" (Recent Monetary Policy), *Kinyuseisaku no Ronten* (Issues of Monetary Policy), (Tokyo: Toyokeizaishinposha, 2000), 224–29.

68. According to Kumano, "two objectives have coexisted in quantitative monetary easing so far. One is to operate short-term interest rates and the other is to stabilize long-term interest

rates. But it is expected that one objective will conflict with the other soon. There is a high possibility that the BOJ will not be able to avoid purchase of government bonds even after they quit quantitative monetary easing.” (Author’s interview with Kumano in March 2005)

69. A former BOJ executive said: “How about the BOJ lending huge amount of money, for example ¥10 trillion, directly to the government without interest? Unlike underwriting government bonds, the government does not need to pay interest. That does not have influence on the bonds market.” (Author’s interview, January 30, 2004).

70. Keiichiro Kobayashi, *Tobi no Daisho—Bukka Geraku to Keizai Kiki no Kaimei* (Compensation for Escape—Understanding Deflation and Economic Crisis), (Tokyo: Nihon Keizai Shimbunsha, 2003), 328–32.

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