The Japanese economy may finally be awakening from its big sleep. Economic activity has picked up, the banking sector is strengthening, and overall confidence in the country’s economic prospects is growing. The good news includes data suggesting that Japan’s nearly eight-year stretch of price deflation is ending. Japan’s core CPI (less fresh food) increased 0.6% on a year-over-year basis in January after gains of 0.1% in December and November. In response to the favorable price pattern, the Bank of Japan announced, on March 9, 2006, that it was ending its quantitative easing policy.

Under this policy, the Bank of Japan set a target for current account balances—essentially non-interest-earning reserve deposits that financial institutions maintain at the Bank of Japan—and purchased government securities and commercial bills until they hit the objective. Over the past two years, the target has been ¥30–¥35 trillion, substantially more than the ¥6 trillion in required reserves that Japanese banks must hold against their deposit liabilities.

The Bank of Japan adopted its policy of quantitative easing in March 2001 to convince markets that it would end price deflation and to boost depositors’ confidence in the financially distressed banking sector. After 1999, when overnight interest rates hit zero and prices generally started falling, short-term interest rates were no longer an effective operating target for monetary policy.

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If the Bank of Japan is to revert to using the uncollateralized overnight call-money rate to guide day-to-day policy, it will need to drain roughly ¥30 trillion in excess reserves from the banking system. It will probably do so by rolling over its holdings of government and commercial bank bills as they mature, rather than selling off securities. This slow reduction of excess reserves in the banking system will keep short-term interest rates very low—as long as economic activity and inflation expectations remain subdued. Over the past seven years, short-term interest rates have been essentially zero, and 10-year government bond rates have generally remained below 2%. After reducing its excess reserves, the Bank of Japan will be able to lift the overnight call-money rate away from zero, but it is not likely to do so without clear, persistent signs that economic activity is improving and prices are rising. Consequently, the Bank will maintain an accommodative policy stance for most of this year.

To provide some guidance as to how it will operate under a call-money-rate target, the Bank of Japan announced a reference range for price stability—its overarching policy goal—of 0% to 2% for core inflation. Presumably, Japanese monetary policy will be more accommodative when the inflation rate is below or in the lower part of this reference range. The Bank emphasized that this range was not a formal inflation target.