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# Fukui prepares to raise rates

**Raising rates in Japan's unbalanced economy will test Governor Fukui's skills to the limit, says Andrew Smithers. But he is on the right track so far.**

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In March, the Bank of Japan announced a change in its monetary policy. This did not involve any change in interest rates, but paved the way for a rise. At the moment commercial banks have more reserves on deposit with the central bank than they are required to hold and, in practical terms, the elimination of these excess balances is a necessary condition for raising interest rates. The change in policy indicates that these balances will now be run down and this appears to be already happening as excess reserves fell sharply in both February and March.

While no definite timetable has been set, it is expected that the reduction in reserves will continue and that, by August, the Bank of Japan will be in a position to end its zero-interest-rate policy and will probably choose to do so around that time. In my article published in February, I pointed out that the central bank's change in policy had been fiercely debated and that it was subject to unusually large risks. The debate has quietened down, as the change is increasingly seen as inevitable, but the risks remain.

**Leaving the zero rate behind**

As table 1 overleaf shows, Japan's economy remains extremely ill-balanced. Japan consumes too little, invests too much and has too large a budget deficit. These imbalances are interrelated. They will have to be corrected over time and it will be extremely difficult for their correction to be smooth. The disequilibria are seldom discussed, which increases the difficulties of dealing with them since it increases the risk of surprise and thus of sudden changes in expectations.

If Japan was a rapidly growing economy, then its high level of investment would be both necessary and stable. But it has had the lowest growth rate among G5 countries for many years and, because its working-age population is falling, this is almost certain to continue. As the return on investment is heavily dependent on the efficiency of capital, the return on new investment has been very poor indeed. The current level of domestic investment is thus unsustainable and very sensitive to either a slowdown in demand, particularly from overseas, or to a rise in interest rates.

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**The deficit problem** The problem of adjusting to a lower level of domestic investment is aggravated by the high budget deficit. In combination, a large shift in the composition of the country's demand is needed, with reductions in investment and in the fiscal deficit. If these falls are not to cause a severe recession, they must be balanced by large rises in demand from either consumption or net exports. But, as Japan is already running a current-account surplus of 4% of GDP, it is clear that the main source of extra demand must be a large rise in consumption.

**Table 1: G5 consumption, investment and budget deficits (% of GDP)**

	Consumption	Domestic investment	Budget balance
France	81.8	20.8	-3.2
Germany	78.5	17.7	-3.9
Japan	72.7	23.3	-6.5
Britain	87.0	16.6	-3.1
United States	86.5	20.5	-3.7

Sources: National data for Q2 2005 for investment and consumption, OECD estimates for general government financial balances for 2005.

As the budget deficit is so big, households not government will have to deliver increased consumption, either through falling savings or rising incomes. Household savings have, however, already fallen sharply in recent years to only around 1.5% of GDP. Although a further fall could keep consumption rising for a year or possibly two, the scope for further falls is clearly limited. A sustained and longer-term improvement in the ratio of consumption to GDP must therefore come from a rise in disposable income. An increase in the share of GDP going to households can only come from either a rise in interest rates or a rise in labour's share of output. Both are likely, as both are currently very low, but either would cause a significant fall in profits.

**Policy dilemmas** Japanese households have exceptionally large amounts of money on deposit, so rising interest rates will help increase their income and encourage consumption. But the counterparts of these deposits are the debts of corporations and the government. As interest rates rise, the government will have to increase taxes, and profits will fall. Thus, although rising interest rates will help consumption, they will also have a negative impact on investment demand and on government finances.

It will be difficult to judge how to increase interest rates in such a way that the negative impact on investment, via profits, will be balanced by the positive impact on personal disposable income and consumption. It will be doubly difficult, in that the process will have to be accompanied by tax increases not only necessary to reduce the deficit, but also to offset the impact of higher interest payments. Since investment tends to be more volatile than consumption, the problem of achieving this balance suggests that the Bank of Japan would be wise to be very cautious in raising rates.

Other considerations, however, point in the opposite direction. Economists today generally agree that central banks need to respond strongly to changes in inflationary expectations as these lead directly to an

acceleration in prices and wage increases. If the central bank's response is weak, then expectations escalate and they can only be brought under control by very high levels of interest rates and a significant loss of output, as happened in the late 1970s and early 1980s.

A sharp change in inflationary expectations does not look to be a problem for 2006. But inflation is picking up worldwide and, after being largely confined to oil, it has become common to most raw materials. If this is not checked, then expectations could start to move sharply next year and require strong measures from central banks.

The Bank of Japan would find this very difficult. Not only would the political pressure against a marked rise in interest rates be intense, but the excessive level of investment makes the economy extremely vulnerable to such changes. It is therefore important for the central bank to keep expectations in check by an early, albeit mild, end to the zero-interest-rate policy.

The classic signals of changes in inflationary expectations come from the currency and bond markets. While the exchange rate has only weakened slightly this year, it has fallen by 40% against the dollar since April 1995, and has been singularly immune to expectations that it would rise in response to the change in monetary policy. The bond market has, however, been notably weak. Since the beginning of the year the yield on ten-year bonds has risen from 1.44% to 1.99% (14 April), which is an increase of 38%.

While it would be premature to claim that the bond and currency markets are already pointing to a worrying shift in expectations of future price rises, they have moved sufficiently to remind the central bank of their importance. The Bank of Japan will need good luck as well as good judgment if it is to keep inflationary expectations under control without pushing the economy back into recession, but there is no justification, I believe, for criticism of its actions so far. □

**Inflation on the horizon**

**Box 1: Fukui on Japan's new monetary framework**

Speaking in Tokyo on 16 March, the governor of the Bank of Japan, Toshihiko Fukui, shed some light on what the central bank's "new framework for the conduct of monetary policy" entailed. First, the central bank has "disclosed a level of the inflation rate that its Policy Board members currently understand as price stability", Fukui said. The board agreed that a year-on-year change in the CPI within "an approximate range between 0% and 2% was generally consistent with the distribution of each member's understanding of medium- to long-term price stability. Most board members' median figures fell on both sides of 1%", Fukui said, adding that the board would review this definition annually.

A second aspect related to communicating the central bank's assumptions. In future, the Bank of Japan will supplement the information contained in its bi-annual *Outlook for Economic Activity and Prices* with "additional examinations of economic activity and prices one to two years in the future," Fukui said. The report will also contain "detailed descriptions with regard to upward and downward risks". "Although the new framework is different from, for example, inflation targetting, [it] improves the transparency of the Bank's monetary policy objective," Fukui concluded.