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The great intervention and massive money injection: The Japanese experience 2003–2004

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A B S T R A C T

From the beginning of 2003 to the spring of 2004, Japan's monetary authorities conducted large-scale yen-selling/dollar-buying operations in what Taylor (2006) has labeled the "Great Intervention." This paper examines the relationship between this "Great Intervention" and the quantitative easing policy the Bank of Japan was pursuing at that time. First, we find that about 40 percent of the yen funds supplied to the market by yen-selling interventions were not offset by the BOJ's monetary operations and remained in the market for a while; this is in contrast with the preceding period, when almost 100 percent were immediately offset. Second, comparing interventions and other government payments, the extent to which the funds were offset was much smaller in the case of interventions, suggesting that the BOJ differentiated between, and responded differently to, interventions and other government payments. These two findings indicate that it is likely that the BOJ intentionally did not sterilize yen-selling interventions to achieve its policy target of maintaining the current account balances of commercial banks at the BOJ at a high level. Finally, we find that an unsterilized intervention had a greater impact on the yen–dollar rate than a sterilized one, suggesting that it matters whether an intervention is sterilized or not even when the economy is in a liquidity trap.

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1. Introduction

During the period from 2001 to 2006, the Japanese monetary authorities pursued two interesting policies. The first of these is the quantitative easing policy introduced by the Bank of Japan (BOJ) in March 2001. This step was motivated by the fact that although the overnight call rate, the BOJ's policy rate, had reached its lower bound at zero percent, it failed to sufficiently stimulate the economy. To achieve further monetary easing, the BOJ therefore changed the policy variable from the interest rate to the money supply. The quantitative easing policy remained in place until March 2006, by which time the Japanese economy had started to recover. The second major policy during this period was interventions in the foreign exchange market by Japan's Ministry of Finance (MOF) and the BOJ, which engaged in large-scale selling of the yen from January 2003 to March 2004.[1] Taylor (2006) has called this the "Great Intervention." The interventions during this period occurred at a frequency of once every two business days, with the amount involved per daily intervention averaging 287 billion yen and the total reaching 35 trillion yen. Even for Japan's monetary authorities, which are known for their active interventionism, this frequency as well as the sums involved were unprecedented.

The main focus of this paper is on how these two policies were related to each other. Researchers often maintain that monetary policy and exchange rate interventions are independent policies.[2] That is, under normal circumstances, monetary policy is conducted by setting a target level for very short-term interest rates (e.g., the federal funds rate in the US, the overnight call rate in Japan) and adjusting the quantity of base money on a daily basis to maintain that level. If the amount of yen funds circulating in the market increases or decreases as a result of foreign exchange interventions, overnight interest rates would deviate from the target level. To avoid this, the central bank offsets the funds supplied to, or absorbed from, the market by the foreign exchange interventions. The central banks of the advanced economies sterilize foreign exchange interventions in this way – an observation that has been confirmed by previous studies, including Craig and Humpage (2001). As long as such sterilization is conducted, monetary policy and foreign exchange interventions are not mutually related.

But did such sterilization also occur even during the period of the "Great Intervention"? In addressing this question, it should be noted that the target level for the overnight call rate was practically zero during this period. Therefore, even if yen funds are additionally supplied to the market by yen-selling interventions, the overnight rate, which is already zero, will not deviate from the target level, so that the BOJ does not need to sterilize those interventions. Rather, the BOJ has reason to actively choose not to sterilize them, because the yen funds supplied through interventions help it to increase base money and thereby achieve its target for commercial bank current account balances at the BOJ.

Taylor (2006) points out that the reason why the US Treasury, which in the past had been critical of Japan's yen-selling interventions, approved of such interventions at this period is that they provided additional support for the BOJ's quantitative easing policy. According to this view, Japan's MOF conducted large-scale yen-selling interventions, which the BOJ did not sterilize, thus allowing an increase in base money, which eventually contributed to the recovery of the Japanese economy.[3] However, the BOJ maintained that there was no causal relationship between large-scale yen-selling interventions and quantitative easing. For example, responding to the report in August 2003 that both yen-selling interventions and the increase in the outstanding balance of current accounts at the BOJ since the beginning of the year amounted to about 10 trillion yen, the Deputy Governor of the BOJ, Kazumasa Iwata, simply stated that this was "coincidence."[4]

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[1] In Japan, it is the MOF which is in charge of foreign exchange interventions. It conducts interventions in conjunction with the BOJ.

[2] See, for example, Craig and Humpage (2001).

[3] The same point was made at the time by Svensson (2001) and Hamada (1999) among others.

[4] On the other hand, in a statement in December 1999, the Governor acknowledged that the BOJ has employed the method of increasing the money base by leaving the funds of yen-selling foreign exchange interventions in the market, saying that "[t]he Bank has been flexibly providing ample funds to the short-term money market taking account of factors including yen liquidity arising from foreign exchange intervention."

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