

## HOW THE FINANCIAL MARKETS RESPOND TO JAPANESE MONETARY POLICY

Japanese monetary policy has not only been effective over the past 15 years; it has also operated in a remarkably similar way to US monetary policy. As **Yuzo Honda** and **Yoshihiro Kuroki** note in a new study of the Bank of Japan's policy actions since 1989, this is particularly surprising given Japan's long period of economic stagnation and the significant institutional differences between the two countries, notably the greater role played by banks and government financial institutions in Japan.

Their article, which is published in the July 2006 issue of the *Economic Journal*, provides a detailed and well documented list of the Bank of Japan's policy actions since 1989. Since the Bank has not always been completely transparent about the desired setting of its policy instrument, such a precise chronology has not previously been available.

The study then goes on to estimate financial market responses – reflected in both the term structure of interest rates and share prices – to surprise changes in the call rate for the Japanese economy, the target rate set by the central bank.

After the bubble burst in 1990, the Japanese economy entered a decade-long period of deflation. Deflation has been rare in advanced economies in the post-war period, but has attracted much attention from macroeconomists. In particular, there has been controversy about the effectiveness of monetary policy among economists and central bankers in Japan and other countries. But until now, there has been little empirical evidence about the efficacy of monetary policy.

This research shows empirically that changes in the call rate are effectively transmitted to long-term market interest rates. In particular, even the ten-year market rate responds significantly to the surprise component of changes in the call rate.

Share prices are also statistically significantly affected by surprise changes in the call rate target. The study finds that a surprise 1% cut in the call-rate target was associated with an increase of roughly 3% in the level of stock prices between July 1989 and March 2001.

In short, there were no problems with the initial aspect of the transmission mechanism of monetary policy for the Japanese economy in this period. Moreover, these findings for the Japanese economy are broadly consistent with the findings of several researchers (including US Fed chairman Ben Bernanke) for the US economy.

This consistency is rather surprising given the significant institutional differences between Japan and the United States. In general, banks in Japan play a greater role than their US counterparts. Government financial institutions, including postal savings, also have a greater role in Japan.

In addition, central banks implement monetary policy differently. Moreover, the period is unusual because it covers Japan's most serious stagnation in the post-war era.

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**Notes for editors:** 'Financial and Capital Markets' Responses to Changes in the Central Bank's Target Interest Rate: The Case of Japan' by Yuzo Honda and Yoshihiro Kuroki is published in the July 2006 issue of the *Economic Journal*.

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