# The Shortcomings of a Zero Interest Rate Policy

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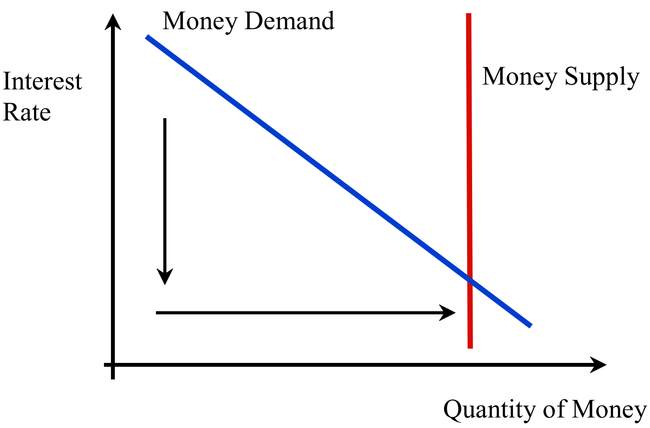
Although there has been a steady trend of declining economic growth in Japan, it still maintains a gross domestic product (GDP) of about $4.8 trillion. In an attempt to rescue Japan's dwindling economy, the Japanese government has adopted a fairly radical approach by keeping its interest rate close to zero since the 1990's in order to advocate increased investment to boost GDP. This has subsequently led to a very low overnight call rate between banks. By maintaining a relatively high money stock of $4.3 trillion (as of 2009), the government has managed to keep the interest rates at near zero percent, as shown by the diagram below:




This approach, however, has been severely criticized by economists due to its inadequacy and the long-term problems it can cause. Japan is now suffering from the decisions the government made back in the 1990's. First of all, with the interest rate already practically zero, the government has been unable to use a valuable monetary tool for two decades that could have been used to stimulate the economy for short-term downturns. Besides that, the policy has also been unpopular due to its inability to actually solve the problem it was meant to, namely the global recession. In a normal cyclical slowdown, lowering interest rates encourages fresh business activity by reducing the cost of borrowing from banks. With more borrowing comes more investment, more jobs and more growth. But these are far from ordinary times. Japanese banks, already burdened with bad consumer and commercial debts, are desperate to clean up their balance sheets and avoid risk — they are not eager to take on more risk by issuing new loans against the backdrop of a deteriorating business climate. They are busy recapitalizing and paring down mountains of bad assets and have little interest in doling out more loans in a moribund economy. Japanese consumers, too, are trying to reduce household debt, so borrowing more money for a new car or to remodel the kitchen is not a high priority. And without greater consumer spending, most companies have little need for new loans to expand operations. Simply put, interest rate cuts don't matter in this environment. ❑