Toshiro Muto: Structural changes in the world economy and challenges facing Japan's economy

Speech by Mr Toshiro Muto, Deputy Governor of the Bank of Japan, at the JCIF International Finance Seminar, Tokyo, 17 June 2003.

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I. Structural changes in the world economy

A. Economic globalization and innovation in information technology (IT)

Looking back, after the turn of the century, at the second half of the 20th century, we can assess it as an era marked by the lengthy Cold War after World War II. Before the close of the 20th century, however, the Cold War came to a dramatic end, with the collapse of the Berlin Wall in November 1989. Behind the change in the Cold War structure, the worldwide spread of the market economy worked as a driving force, as seen in the expansion of free markets in the former Soviet Union and Eastern Europe.

The end of the Cold War further accelerated globalization of the market economy in the 1990s. Eastern Europe joined the world trade structure and has been playing an increasingly important role as a supply base especially in the euro area. In Asia, China, which had already introduced the market mechanism before the end of the Cold War, has become a giant supply base for developed countries including Japan. Exports from China currently account for approximately 15 percent of world exports after adjusting for purchasing power parity, a rise from around 5 percent in 1990. In the United States, imports from Latin America currently account for approximately 16 percent, an increase from around 11 percent in 1990. These facts vividly illustrate the trend of economic globalization driven by the chemistry of market mechanisms and changes in the international political system.

B. Industrialization of emerging economies and development of IT-related industries

Against the background of the economic globalization in the 1990s, emerging economies have industrialized rapidly and elevated their importance in the world economy. In the meantime, innovation in IT has also contributed to economic globalization, nurturing the IT-related industries that came to have great influence on the world economy. Since the IT-related industries have a multinational structure involving emerging economies, the growth in IT-related industries inevitably strengthened global economic linkages.

Although these changes will help facilitate new economic structures in the long run, they sometimes engender negative aspects. The global inventory adjustments in IT-related areas that began around the end of 2000 are still fresh in our memories. In these developments, not only the United States but also Europe and Japan, as well as East Asian economies, experienced simultaneous stagnation due mainly to the decrease in exports, production, and investment in IT-related areas.

C. Globalization of financial markets

The expansion of the market economy and technological innovation have encouraged the development of financial markets in emerging economies, as well as realized new financial instruments such as derivatives. They have consequently strengthened global linkages of capital markets.

The globalization of financial markets has facilitated the rapid industrialization of emerging economies by promoting capital inflows. On the other hand, financial crises in certain countries or areas could spread more easily than before to other countries, as seen in the Asian currency crisis in 1997, the Russian financial crisis, and the collapse of Long-Term Capital Management in 1998. Central banks in many countries, including the Bank of Japan, have cooperated in various forms of research on this issue recently.

D. Worldwide disinflationary trend

Structural changes in the world economy also affect the environment for prices. A worldwide disinflationary trend had become conspicuous in the 1990s, reflecting an increase in supply capacity worldwide due to the industrialization of emerging economies, technological innovation, and macroeconomic policies adopted in many countries to restrain inflation. Inflation rates in the G-7 countries averaged about 10 percent during the 1970s and about 5 percent during the 1980s. The simple average of the rates, however, declined to 2-3 percent after the start of the 1990s, and in the second half of the decade remained at 2-3 percent in the United States, United Kingdom, and Italy, and fell below 2 percent in the other G-7 countries. Japan has been experiencing gradual deflation, as consumer prices have ranged from -1 to zero percent year on year since the middle of 1998.

In Europe and the United States, this disinflationary trend has brought real economic benefits, by securing a stable foundation for economic activity. The United States enjoyed a long-lasting economic expansion accompanied by price stability during the 1990s. The improvement in productivity reflecting technological innovation in IT-related industries has often been credited with this, particularly in discussion of the so-called “new economy.” In Europe, European Monetary Union was achieved since inflation rates in the countries joining the union declined to levels that satisfied the convergence criteria.

On the other hand, central banks in many countries are becoming increasingly concerned with the risk of price declines, which have not occurred in the decades since the Great Depression. The background to this is that inflation rates, particularly those of major industrialized countries, have trended downward to nearly zero percent amid the disinflationary trend worldwide. Although it does have a positive effect on real economy, it has brought about the risk that inflation rates could turn negative if downward pressure on prices increases from either the demand or supply side.

The Federal Reserve lowered the federal funds rate gradually from 2001 in response to economic developments, and it has accordingly declined from 6.5 percent at the start of 2001 to 1.25 percent. The European Central Bank (ECB) also gradually reduced the main refinancing operations rate from 4.75 percent at the beginning of 2001 to 2.5 percent, followed by a further reduction to 2.0 percent on June 5, 2003. In line with such monetary policy developments, central banks overseas sometimes refer to the risks of price declines in their statements. The Federal Reserve, for example, commented that “the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level” in its public statement after the meeting of the Federal Open Market Committee on May 6, 2003. In addition, several central bank officials have commented on the manoeuvrability of monetary policy against the background of price declines.

Conventional monetary easing calls for reducing short-term interest rates. However, there has been no definite answer yet, either theoretically or empirically, to the question of whether there remains scope for further stimulation of economic activity with monetary policy measures under the “zero lower bound” of short-term interest rates. For this reason, central banks overseas are paying greater attention to the conduct of monetary policy by the Bank of Japan, which has taken unprecedented quantitative easing measures since March 2001.

II. Issues facing the Japanese economy

A. The catch-up of emerging economies

Bearing in mind the structural changes worldwide I have described, I would like to focus on the issues facing the Japanese economy.

During the Cold War period, Japan achieved remarkable economic growth, driven mainly by the enhanced competitiveness of the manufacturing sector, to the extent that Japan became known as the “factory of the world.” However, many of the Japanese industries that brought about the economic growth in the postwar era are now facing competition from their counterparts in emerging economies that are rapidly catching up.

The share of trading partners in Japanese exports and imports has changed substantially. In the past, the United States took the overwhelming majority of Japanese exports, and a fairly large proportion of imports were from oil producing countries. However, the share of imports from the Middle East, which was nearly 30 percent in the mid-1970s, has been declining, to about 10 percent recently. On the other hand, the share of trade (both exports and imports) with East Asian economies, which was around 25 percent in the mid-1980s, recently exceeded 40 percent. In particular, the share of imports from China in total Japanese imports expanded to 18 percent in 2002 from 5 percent in 1990. The share of imports from China has overtaken that from the United States, making China the largest importer for Japan.

An examination of imports reveals that the character of Japan's trade structure - importing raw materials for manufacturing and exporting products - has changed. For instance, the share of raw materials in total imports from East Asian economies has declined to about 15 percent recently, from about 35 percent in 1990. In the meantime, that of machinery and textile goods has exceeded 50 percent recently, compared with around 25 percent in 1990. The degree of penetration of imported products in the domestic market illustrates a rise in the value added to imported products. In the 1990s, the growth in penetration of textile goods was conspicuous, but since 2000 it has leveled off at around 30 percent. The penetration of electrical and general machinery has increased to nearly 30 percent very recently, from 17-18 percent in 2000.

These changes reflect progress in industrialization and the accumulation of technology in East Asian economies since 1990. They are also attributable to Japanese firms' activities to transfer production sites overseas. At the same time, these changes make us consider what kinds of industries we should nurture and what types of economic value we can create as sources of Japan's future growth.

B. The aging economy

Japan is shifting from a growing economy to a mature one at an unprecedentedly fast pace. Since the second half of the 1980s, Japan's birthrate has been declining significantly and the aging of the population pyramid has accelerated. The nation's population is expected to decrease from 2006. Given these circumstances, the Japanese socioeconomic system, including the employment system, social security, local budget and tax systems, needs to be drastically reconstructed from one based on a growing economy to one suited to a mature economy.

The reforms of the system comprising the economy and society of a nation inevitably entail conflicts of interest, and it is becoming increasingly difficult to resolve such conflicts through the benefits from economic expansion. Thus, it is a very difficult challenge indeed for Japan to implement reconstruction of its socioeconomic system in order to catch up with changes in economic and social environments, while achieving a national consensus.

C. Emergence and bursting of the bubble economy

Given the various changes I have mentioned, from the second half of the 1980s through the 1990s it was necessary for Japan to embark on nurturing new industries that could be the leading industries in the 21st century, as well as implementing fundamental changes in its socioeconomic system. However, during that period the bubble emerged and burst, and caused serious delay in such structural changes.

Overheating of domestic demand and a sharp rise in asset prices due to the bubble allowed inefficient sectors to be preserved and permitted unprofitable investment businesses to expand. In the financial sector, a substantial rise in land prices caused an expansion of bank lending in a period when more emphasis should have been placed on financing through capital markets and securitization.

Furthermore, the bursting of the bubble combined with characteristics of the financial system indigenous to Japan - a high proportion of bank lending - caused serious problems that restrained economic activity for a long time, such as the problems of nonperforming loans (NPLs) and firms' debt overhang. Efficient reallocation of resources through structural adjustments should have been realized as a result of risk-taking activities of various economic entities to explore business frontiers. However, the financial strength of banks and firms and hence their risk-taking capacity were damaged significantly. Against this background, macroeconomic policies in the 1990s had to continuously deal with downward pressure on the economy stemming from the bursting of the bubble.

D. Recent developments in the economy

Now I would like to touch briefly on the recent developments in the economy. In the first half of 2002, Japan's economy recorded relatively high growth supported by an increase in exports that reflected global inventory restocking in IT-related goods. Since the second half of 2002, however, economic activity in Japan has been basically flat. Despite the fact that corporate profits have recovered reflecting the increase in exports and production, firms have not yet embarked on active investment due to uncertainty about the economic outlook. The employment and income situation of households remains severe, as firms have continued to reduce personnel costs. In this situation, private consumption, which constitutes a major part of aggregate demand, remains flat, although it is fairly firm relative to the level of income.

With regard to the outlook, Japan's exports are expected to start increasing at a moderate pace, based on the assumption of a gradual recovery in overseas economies. However, the pace of the recovery in Europe and the United States is likely to be moderate. In addition, it seems likely that the growth in East Asian economies, which has been fairly rapid so far, has slowed at least for the time being due to the impact of severe acute respiratory syndrome (SARS). We must continue careful monitoring of Japan's economy, taking into account the effects from the developments in overseas economies and Japan's financial system.

III. Monetary policy of the Bank of Japan

A. Conduct of monetary policy

In order to place the economy back on a sustainable growth path and overcome deflation as soon as possible, the Bank has been implementing extraordinary monetary easing measures, which far exceed the category of "conventional" monetary policy.

In March 2001, the Bank implemented the "quantitative easing" framework to increase further its liquidity provision to the money market in a situation where short-term interest rates had declined to virtually zero. The outstanding balance of current account deposits at the Bank expanded from 4 trillion yen at the time to close to 30 trillion yen at present. The Bank announced that it would continue the framework of the quantitative easing until the consumer price index (CPI) records a year-on-year increase of zero percent or more on a sustainable basis. The Bank also steadily increased its purchases of Japanese government bonds (JGBs), and is currently purchasing a little less than 15 trillion yen worth of JGBs annually, which is roughly equivalent to half the total value of newly issued government bonds. The Bank also introduced the Lombard-type lending facility whereby financial institutions can borrow funds, within the eligible collateral pledged, from the Bank at the official discount rate that is now 0.1 percent. The Bank has widened the range of eligible collateral to asset-backed securities (ABSs) and many other new financial assets.

As I mentioned earlier, several central bank officials overseas have commented recently on conceivable options of monetary easing under the "zero lower bound" of short-term interest rates. As possible measures to be taken solely by the central bank, they raised the increase of liquidity provision, the announcement to continue monetary easing into the future, the increase of the outright purchases of government securities, extending the central bank's discount windows to commercial banks with low interest rates, and widening the range of eligible collateral. The Bank has already implemented most of these unconventional measures in its quantitative easing framework.

The effects of extraordinary easing measures by the Bank of Japan have been observed in financial markets. Even when there were various shocks due to problems in the domestic financial system, the terrorist attacks in the United States, and the military action against Iraq, a liquidity shortage did not materialize in the money market, and short-term interest rates have continued to be virtually zero, including longer-term rates such as those on term instruments. This situation is a marked contrast with that in 1997-98 when the failure of a few large financial institutions triggered concerns about the availability of liquidity at Japanese banks, and as a result, the so-called "Japan premium" expanded and a sharp credit contraction occurred in corporate financing.

The Bank's policy commitment - that it will continue the current framework of monetary easing until the CPI records a year-on-year increase of zero percent or more on a sustainable basis - leads market participants to believe that short-term interest rates will continue to be zero at least until the actual inflation rate turns positive. As a result, risk premiums reflecting future fluctuations in interest rates have declined considerably, and the decline in interest rates has spread to even longer-term rates. The yields on five-year JGBs are in the range of 0.1 and 0.2 percent, those on ten-year JGBs have fallen below 0.5 percent, and those on 30-year JGBs are around 1 percent. Thus, the government is able to raise funds at almost zero or an extremely low cost. The cost for the private sector of raising funds has also declined.

However, despite drastic monetary easing by the Bank, economic activity and price developments have not been influenced much so far. This is due to various factors. First, there was originally very little room for interest rates to decline further. As a consequence of the Bank's large-scale monetary easing since the bursting of the bubble, the overnight call rate was already below 0.5 percent in 1995, and long-term interest rates were already at around 1.5 percent at the time of the introduction of the quantitative easing framework. In this situation, the effects of various additional easing measures have remained marginal, especially when the economy has been under substantial adjustment pressures. The concern of many central banks about the risks of a price decline is based on a reflection of such uncertainty and limitation of the effectiveness of monetary easing under the "zero lower bound" of short-term interest rates.

The second factor, as I mentioned earlier, is that the risk-taking capability of private entities, such as commercial banks and firms, has been greatly impaired. The transmission mechanism of monetary easing effects depends heavily on private entities' risk-taking activity. In a normal situation, liquidity provision by a central bank to commercial banks encourages more lending because their liquidity constraints are eased. However, at present, the capital constraints arising mainly from the NPL problem, not liquidity constraints, bind commercial banks' lending capacities. This is the major reason why bank lending has continued to decline and the growth in the money stock has been sluggish, although the monetary base has been expanding.

Furthermore, whether the portfolio rebalancing effect - that is, the mechanism whereby a central bank's increase of liquidity provision still increases financial institutions' investment in risk assets even after short-term interest rates reach the zero bound - occurs also depends on the extent to which financial institutions actively take risks. So far, they have been reluctant to take risks, and have mostly invested funds provided by the Bank in credit-risk-free assets such as cash, excess reserves, and government securities. As I have mentioned, the Bank is struggling under many constraints, not only the "zero lower bound" on interest rates which is a fundamental problem in monetary easing, but also the impaired risk-taking capability of the private sector, and malfunctioning of the transmission mechanism of monetary easing.

This has been an issue not only in monetary policy but also in recent macroeconomic policy as a whole in Japan. Throughout the 1990s, I was in charge of executing fiscal policy. During the period, Japan has taken substantial measures both in monetary and fiscal fronts. However, given that fiscal policy is determined in the political situation at the time, and since the growth expectation has been declining and the private sector's risk-taking capability has been impaired, multiplier effects of public investment and tax cuts have also been constrained. As the central bank has been struggling with the problem of malfunctioning of the transmission mechanism, the fiscal authorities have also been struggling with the problem that fiscal expenditure has not led to vigorous spending by the private sector.

B. Issues regarding further policy measures

There are various debates outside the Bank about further policy options, and the Bank is always examining a wide range of imaginable options. I would like to raise some points that I think are important in discussing future policy conduct.

First of all, we must bear in mind that Japan's efforts to overcome deflation ultimately aim at realizing the sound and continuous prosperity of its economy. With a growing number of countries shifting to a market-led economy and economic globalization advancing, it is essential to make full use of the private sector's initiatives and market mechanisms as well as maintain favorable relationships with other economies for Japan to continue enjoying economic prosperity in the future. If Japan took policy measures that distorted market mechanisms in the medium to long term, caused inefficiencies in the economy, or greatly impaired relationships overseas, the prospects for economic prosperity in the 21st century would be substantially narrowed. It is important that various policy options be consistent with the direction desired for the economy.

Furthermore, in conducting economic policies, it is essential to maintain the capacities to respond to various shocks and uncertainties, which are often unpredictable because of imperfect knowledge, in order to secure economic stability. Once the confidence of the public and market participants in such capacities of economic policies is lost, this can cause serious instability in the economy and financial markets. Past experience tells us that public confidence in policy entities, once lost, is extremely difficult to restore in a short period of time.

As an independent central bank, the Bank should bear in mind its accountability to the public for its policy measures. There have been the arguments outside the Bank that the Bank purchases risky assets that central banks normally do not purchase. In this respect, we must bear in mind that the central bank ultimately belongs to the people. If a central bank buys some assets, it virtually means that it uses the people's money to buy them. In the current situation where short-term interest rates have reached the zero bound and conventional monetary easing tools have been exhausted, the Bank must consider measures that go beyond the boundaries of traditional monetary policy and sometimes approach the realm of fiscal policy. However, it is vital for the Bank to evaluate policy options from the perspective of whether they are consistent with the Bank's accountability to the public and thus make a balanced judgment. This point becomes all the more serious as policy options could have greater influence on the distribution of income and risks in the private sector.

C. Issues of inflation targeting

I would like to briefly talk about issues of inflation targeting. Inflation targeting is a policy framework adopted in several countries in which a state of price stability, the goal of monetary policy, is expressed in terms of a desirable rate of inflation in numerical values. I think that the background of the argument regarding inflation targeting in Japan differs somewhat from the original thinking that I have described. The thinking that underlines the current argument advocating the adoption of inflation targeting in Japan seems to be as follows: real interest rates, which are derived by subtracting the inflation expectation rate from nominal interest rates, might be reduced if the inflation expectation rate increased, and declaration of a numerical target might contribute even when there is virtually no room for further reduction in nominal interest rates.

Whether inflation targeting brings about its intended benefit, that is, to enhance the transparency of monetary policy and to stabilize people's expectation, largely depends on the following: how credible is the target? That is to say, to what extent are the tools and mechanism to achieve the target assured? As of now at least, it is hard to say that we are sufficiently equipped, considering the several constraints surrounding the current conduct of monetary policy.

Like any other central bank, the Bank needs to examine every possible measure to enhance the transparency of its conduct of monetary policy. The Bank fully recognizes the fact that inflation targeting could be an important policy tool for the purpose, once we enter the stage where manoeuvrability is restored to monetary policy and the transmission mechanism recovers its function. The Bank will continue to examine the issue in the future. Bearing the lack of such manoeuvrability and the malfunctioning of transmission mechanism at present, however, I think it is critically important and urgent to take practical steps to restore the effectiveness of the transmission mechanism through which monetary easing influences economic activity and prices.

I would like to emphasize that it would be a complete misunderstanding of the Bank's policy intention to conclude that the Bank is not actively implementing monetary policy to overcome deflation, based solely on the fact that the Bank does not adopt inflation targeting at this juncture. The Bank is willing to bring the inflation rate back to above zero percent, that is, a slightly positive rate, by doing its utmost and to maintain it at around that level.

D. Enhancing transmission mechanism of monetary easing

Amid various constraints imposed on its policy as I have mentioned, the important policy task of the Bank is to enhance the transmission mechanism of monetary easing. As the credit intermediary function of banks is not working properly, one of the contributions of the central bank to enhance the transmission mechanism is to encourage the development of securitized financing tools and capital markets that could complement and substitute for bank lending, and improve the financing environment for small firms.

The relatively high share of bank lending, which is one of the features of Japan's financial structure, contributed to absorbing shocks from the downturn in economic activity within banks' assets, and thus succeeded in diminishing their effects on the economy as long as the impacts of the shocks were limited. However, when significant shocks such as those accompanying asset price falls occurred, the concentration of the loss to the banking sector caused substantial damage to its capital base and risk-taking capability. This, in turn, amplified the effects of the shocks through tightening of corporate financing conditions.

This problem could be partially resolved if alternative financial markets substituting for bank lending were developed to a significant degree. The development of such markets would not only contribute to smooth corporate financing, it would also work as a discipline on banks' lending activities, for example, by encouraging banks to formulate lending rates which reflect credit risks more accurately. In addition, broadening the scope of economic entities that take credit risks attached to the corporate sector could enlarge the risk-taking capacity of banks. Investors would be able to realize portfolios by utilizing a broader range of instruments with various combinations of risks and returns. A new financing channel of this kind is imperative to cope with the financing needs of the corporate sector, as the economy becomes mature.

Based on this thinking I have described, this April the Bank started examining the policy option of temporary purchase of ABSs with underlying assets such as receivables and loans related to small to medium-sized firms. The Bank decided the purchasing scheme at the Monetary Policy Meeting on June 11, 2003, taking into account various comments from market participants. Although it is an unconventional measure for a central bank to directly take on private-sector credit risk, we thought it necessary to promote smooth corporate financing by nurturing the ABS market and to enhance the effectiveness of monetary easing, giving due consideration to the required functions of Japan's financial system in the future and the current weakness in the credit intermediary function of the banking system. At the same time, the Bank will pay careful attention to avoid distortion of the ABS market and to maintain the soundness of the Bank's balance sheet.

IV. For the revitalizing of Japan's economy

A. The need for efforts by a wide range of economic entities

I would like to briefly discuss my thinking on the efforts necessary to revitalize Japan's economy.

As I mentioned at the outset, the world economy is undergoing structural change and industrialization in emerging economies is advancing. In this situation, Japan should foster new industries that will lead the economy in the 21st century with high productivity and value-added that are suitable to a developed nation. Such efforts are indispensable to ensure economic prosperity in the future, since we will not be able to count on an increase in the population as a source of economic growth and an improvement in productivity is virtually the only way to create growth.

At the same time, it is necessary to drastically reconstruct the socioeconomic system, which has been based on an expanding economy, into one fitted to a mature economy. It is very difficult to achieve a national consensus regarding changes in the system itself. If the changes in the socioeconomic system cannot catch up with the actual economic and social developments, however, economic revitalization will be hampered through the effects of the disincentives.

There is another problem regarding private economic entities: the risk-taking capability of financial institutions and firms is impaired because of the sluggish growth expectation after the bursting of the bubble. This problem undermines the effect of various policy actions.

Therefore, the efforts of the government, the private sector, and the central bank must be concerted to overcome such complex issues facing the economy. As part of this, Japan should present a vision of the future socioeconomic system it seeks to attain, including the social security system and the relationship between the central and local governments, and seek to continuously take actions in accordance with this vision.

Japan's prosperity in the 21st century should be achieved through maximum utilization of private-sector initiatives and market mechanisms, as for example an investment and funds intermediary, throughout the economy. At present, the private sector cannot fulfill the role to the utmost because of its limited financial strength, and in some cases public authorities are required to support private-sector initiatives. The Industrial Revitalization Corporation of Japan established last month is a major example of a public initiative to support private activities, and I hope it will be utilized effectively and contribute to the revitalization of the economy.

At the same time, such policies and support as a whole must be in line with the nation's vision, that is, an economy exploiting the full benefits of private-sector initiatives and market mechanisms. Continuing to take these policy actions in harmony with the future visions will heighten the growth expectation of the private sector and induce demand.

B. Reviving the financial system

Finally, I would like to comment more specifically on issues concerning the Japanese financial system.

In order to revive the economy, it is indispensable to realize a situation in which Japan's financial system performs the credit intermediary function fully. Discussion on putting the financial system on a sounder basis often focuses attention on the disposal of NPLs. Although this issue is very important, the disposal of NPLs is just one of the prerequisites for achieving the much broader task of reviving the financial system. The most vital necessity in the medium to long term is to construct a new financial infrastructure, which can play a key role in the economy in the 21st century.

After World War II, Japanese financial institutions raised their profitability by maintaining a certain asset size, supported by high economic growth and private savings. In undertaking risk management, a basic function of commercial banks, most of the work associated with assessing the profitability and risk of each individual project was often substituted by monitoring the price of real estate that had been pledged as collateral. This system was based on the condition that real estate prices continued to rise.

Market participants are now keenly watching whether Japanese financial institutions can generate a new business model and establish a sufficient foundation for profitability in the future, now that the external environment that supported their profitability in the postwar era has drastically changed. The value-added and the profit of financial institutions are ultimately generated from their activities of taking and controlling various risks such as credit risk, interest rate risk, and liquidity risk. For the Japanese financial system and economy to revive, it is extremely important that Japanese financial institutions create a new business model that ensures a foundation for profitability while supporting the Japanese economy in the 21st century. I think it is essential for financial institutions to make further efforts in this respect.

The Bank of Japan will make its best effort on various fronts, such as enhancing the transmission mechanism of monetary easing, promoting the permeation of the easing effects through the economy, as well as ensuring financial market stability. As other developed countries are keenly watching our monetary policy conduct, it is my sincere hope that Japan realizes sustainable economic growth accompanying price stability, and succeeds in recording a victory over deflation.