

Toshihiko Fukui: Bank of Japan's conduct of monetary policy - an overall review

Statement by Mr Toshihiko Fukui, Governor of the Bank of Japan, concerning the Bank's Semiannual Report on Currency and Monetary Control, before the Committee on Financial Affairs, House of Representatives, Tokyo, 9 June 2004.

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Introduction

The Bank of Japan submitted its *Semiannual Report on Currency and Monetary Control* for the second half of fiscal 2003 to the Diet on June 4, 2004. I am pleased to have this opportunity to present an overall review of the Bank's conduct of monetary policy.

I. Developments in Japan's economy

When I spoke to this committee in March 2004, I presented the assessment that Japan's economy was recovering gradually. Since then, industrial production and corporate profits have continued to increase due to a substantial rise in exports, and against this background business fixed investment has continued to recover. The decline in household income is gradually coming to a halt, and private consumption is showing some positive movements. With a virtuous cycle in operation, the economy continues to recover gradually and domestic demand is becoming firmer.

As for the outlook, Japan's economy is expected to continue its recovery as momentum increases gradually.

Overseas economies are likely to continue growing relatively fast, despite some negative factors such as geopolitical risks and the rise in crude oil prices. The U.S. economy continues to show balanced growth. Private consumption and business fixed investment remain firm, and in the employment situation a recovery which had been delayed is becoming clearer. East Asian economies, particularly China, are likely to continue high growth. Reflecting such developments in overseas economies, Japan's exports and production are expected to continue on an increasing trend.

Furthermore, corporate profits are likely to remain on an uptrend as exports and production increase, given the progress in dealing with problems, such as excessive labor and debt, which were part of the background to the delay in Japan's economic recovery. Business fixed investment is therefore likely to continue on an uptrend, particularly in the manufacturing sector. The increase in production and corporate profits is expected to exert positive effects gradually on the household sector through changes in employment and income as well as in asset prices. Against this background, private consumption is expected to recover at a moderate pace.

On the price front, domestic corporate goods prices have been rising recently, due to the strengthening of commodity prices at home and abroad and to the improvement in supply and demand conditions, and they are expected to continue increasing for some time. The year-on-year rate of change in consumer prices (excluding fresh food) has been close to zero percent. As for the outlook, the output gap, which affects the underlying trend of prices, is expected to narrow steadily, but temporary factors, such as the increase in rice prices that has contributed to a slowdown in the year-on-year rate of decline in consumer prices, will dissipate gradually. Furthermore, the increase in productivity in the corporate sector is likely to absorb the effects of the rise in commodity prices. Given this situation, consumer prices are basically projected to continue falling slightly on a year-on-year basis.

As for the recent rise in crude oil prices, however, future developments and their effects require close monitoring.

The money market continues to be stable overall against the background of the Bank's provision of ample liquidity. In the capital market, Japanese stock prices declined temporarily from late April given declines in stock prices and rises in interest rates worldwide, but they rose thereafter. Long-term interest rates have been stable on the whole, but are recently rising somewhat.

The environment for corporate finance is becoming more accommodative on the whole, although it remains severe for firms with high credit risks. The rate of decline in lending by private banks has been

diminishing slightly, and the fund-raising environment for firms in the capital market through corporate bonds and CP continues to be favorable.

II. Conduct of monetary policy

The Bank has been conducting the quantitative easing policy with the outstanding balance of current accounts held at the Bank as the operating target. In accordance with the current target range for the outstanding balance of “around 30 to 35 trillion yen,” the Bank provides ample liquidity to the money market. The Bank has also made a commitment to maintain the quantitative easing policy until the year-on-year rate of change in the consumer price index (CPI; excluding fresh food, on a nationwide basis) registers zero percent or higher on a sustainable basis.

Against the background of this policy, financial institutions have been more confident in raising funds in the money market, and this has been contributing to stability in financial markets. The Bank’s commitment to maintaining the policy has contributed to stabilizing market participants’ projection of future interest rates, and thus market interest rates have been stable. In this situation, firms have been able to raise funds at low interest rates. Reflecting the recovery of the economy, firms’ returns on investment are expected to increase, and the current quantitative easing policy will therefore further promote their positive activity. The effects of the quantitative easing policy will support the economy more strongly as it continues to recover.

With these points in mind, the Bank has continued to conduct its quantitative easing policy with the commitment based on the CPI.

The Bank has been making efforts to make credit intermediation in the market more diversified and efficient so that monetary easing effects permeate further throughout the economy, and these efforts are expected to improve the Japanese capital market in the long term. As part of such efforts, the Bank started to purchase asset-backed securities (ABSs) from July 2003, and the total amount of ABSs purchased to date has reached around 800 billion yen. In addition, the Bank hosted the Workshop on Securitization, and exchanged views about practical problems and possible solutions with market participants to back the development of the ABS market. In April 2004, the Bank released the results of the discussions held at the Workshop, which contained specific proposals, for example, a proposal that prices of securitized products should be evaluated more accurately and efficiently.

In May, the Bank introduced a facility which provides the markets with Japanese government securities (JGSs) held by the Bank as a secondary source with a view to enhancing the liquidity of JGS markets. The Bank has been making a wide range of efforts to improve the infrastructure of financial markets and will continue to do so.

III. Purchases of stocks held by commercial banks

The Bank started to purchase stocks held by commercial banks from November 2002 to reduce the risk that stock price fluctuations might impact negatively upon the business management of individual financial institutions, potentially resulting in instability of the financial system as a whole. The total amount of stocks purchased by the Bank as of May 31, 2004 was 1,979.9 billion yen.

Conclusion

Japan’s economy is expected to continue recovering as it gains further momentum gradually. To ensure that this recovery will become sustainable and to overcome deflation, the Bank considers it essential that a wide range of economic entities continue to make efforts to revitalize the economy.

The Bank is determined to firmly support Japan’s economy by continuing with monetary easing even as the economy continues to recover, in order to realize sustainable growth and overcome deflation.