

## **Toshihiko Fukui: Semiannual report on currency and monetary control**

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 Councillors, Tokyo, 18 October 2005.

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### **Introduction**

The Bank of Japan submitted its Semiannual Report on Currency and Monetary Control for the second half of fiscal 2004 to the Diet in June 2005. 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**

Japan's economy has emerged from its temporary pause that started during the summer of 2004, and continues to recover.

Exports are continuing to increase moderately against the background of the expansion of overseas economies, although the momentum of export growth, especially to China, weakened temporarily. Production is on an uptrend with some fluctuations, partly due to the completion of inventory adjustment in IT-related sectors. Business fixed investment is growing steadily in a wide range of industries, as corporate profits remain high and business sentiment has been showing a gradual improvement. As for the household sector, after a prolonged period of difficulty due to firms' efforts to reduce excess labor and personnel expenses, household income has been rising moderately, as the number of employees has been increasing and wages have picked up. With this improvement in the employment and income situation, private consumption has been steady.

Looking forward, exports are expected to continue rising against the background of the expansion of overseas economies. Domestic private demand is likely to continue increasing against the backdrop of high corporate profits and the moderate rise in household income, as structural adjustment pressure stemming from firms' excess capacity and labor has almost dissipated. Given this situation, the economy is likely to experience a relatively long period of growth, albeit at a moderate pace. Nevertheless, there are risk factors such as the continuing surge in crude oil prices and its possible effect on overseas economies, and these should be monitored closely.

On the price front, domestic corporate goods prices have been increasing mainly reflecting the effects of high crude oil prices, and this uptrend is expected to continue. Consumer prices (excluding fresh food, on a nationwide basis) have been declining slightly on a year-on-year basis partly due to the reduction in electricity and telephone charges against the background of such factors as deregulation. The year-on-year rate of change in consumer prices is projected to be zero percent or a slight increase toward the end of the year, as the effects of temporary factors, such as the decline in rice prices and the reduction in electricity and telephone charges, fall off. The year-on-year rate of change in the consumer price index (CPI) is expected to increase thereafter, as the Japanese economy is likely to continue growing at above its potential rate, causing the gap between supply and demand to shrink further.

On the financial front, the environment for corporate finance is becoming more accommodative on the whole. The lending attitude of financial institutions has been becoming more active. Under these circumstances, the negative year-on-year change in the amount of lending by private banks observed since 1998 has gradually improved, and the amount of their lending is currently at around the previous year's level. The environment in the capital markets for firms raising funds through CP and corporate bonds continues to be favorable.

## **II. Conduct of monetary policy**

The Bank has been providing ample liquidity based on the quantitative easing policy. At the Monetary Policy Meeting (MPM) on October 11 and 12, 2005, the Policy Board decided to maintain the target range for the outstanding balance of current accounts held at the Bank at "around 30 to 35 trillion yen."

The framework of the quantitative easing policy is based on two key elements. The first element is the Bank's provision of ample liquidity to the money market so that the outstanding balance of current accounts at the Bank substantially exceeds the amount of required reserves. The second is the Bank's commitment to firmly maintain this ample provision of liquidity until the year-on-year rate of change in the CPI registers zero percent or higher on a sustainable basis.

Regarding the first element, the Bank's provision of ample liquidity contributed greatly to maintaining financial system stability and an accommodative corporate financing environment by responding to financial institutions' precautionary demand for liquidity when there were strong concerns about financial system stability. Since then, such concerns have largely subsided, as evidenced by the smooth implementation of the full removal of blanket deposit insurance in April 2005. As a result, financial institutions' precautionary demand for liquidity has been on a declining trend. Under these circumstances, since the MPM held on May 19 and 20, 2005, the Bank has been allowing the outstanding balance to temporarily fall below the target range when it is judged, in a situation where the Bank is doing its utmost to provide funds while at the same time giving due consideration to the effects on the functioning of the market, that financial institutions' liquidity demand is exceptionally weak. This decision is intended to enable the quantitative easing policy to be conducted more smoothly by making it possible for liquidity to be provided with a minimum of hindrance to the process of price formation and efficient allocation of funds in the financial markets.

In the current situation, the quantitative easing policy contributes to maintaining an accommodative financial environment by stabilizing market interest rates, thus allowing firms to continue to enjoy low funding costs. The commitment's positive effects through interest rates on the economy are strengthening as corporate profits increase with economic recovery.

## **Conclusion**

Japan's economy has emerged from its temporary pause and continues to recover. As for the outlook, it is likely to experience a relatively long period of growth, albeit at a moderate pace, and the Bank will continue its close monitoring of developments. At the meeting of general managers of the Bank's branches scheduled for October 20, the Bank will examine the state of the economy in each region thoroughly based on the report presented there.

The Bank will continue to conduct monetary policy appropriately based on careful examination of developments in economic activity and prices. In the current situation where the CPI has been declining slightly on a year-on-year basis, the Bank is determined to support Japan's economy from the financial side to achieve sustainable economic growth with price stability, by maintaining monetary easing in accordance with the commitment based on the CPI.

The Bank will also continue to pursue more advanced central bank services as well as ensure well-disciplined management, according to a Medium-Term Strategic Framework for fiscal 2005-2009 formulated in March 2005, in order to properly carry out the duties entrusted to it as the nation's central bank.