

Masaaki Shirakawa: Overall review of the Bank of Japan's conduct of monetary policy

Statement by Mr Masaaki Shirakawa, 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, 22 May 2008.

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Introduction

The Bank of Japan submitted its *Semiannual Report on Currency and Monetary Control* for the first half of fiscal 2007 to the Diet on December 11, 2007. 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 economic growth is slowing, mainly due to the effects of high energy and materials prices.

The deterioration in the terms of trade that results from rises in energy and materials prices leads to an outflow of real income, as Japan depends heavily on imported resources. This exerts downward pressure on corporate profits and reduces households' purchasing power. Although business fixed investment and private consumption remain firm, due attention should be paid to the possibility that the weakening of the economy's capacity to generate income will result in weaker domestic private demand.

As for the outlook, Japan's economy is likely to grow at a slower pace for the time being and follow a moderate growth path thereafter. Exports are expected to continue rising – even though those to the United States have been falling for some time – as they have been increasing to a broader range of destinations, particularly emerging economies and countries that export natural resources. In the corporate sector, firms currently face no excess in production capacity, inventory, or employment, and corporate profits have been at historically high levels. As a result, it seems that Japan's economy has become more resilient against negative shocks than in the past. The accommodative financial conditions are likely to continue to support private demand. The level of short-term interest rates has been very low relative to the potential growth rate and inflation. In addition, firms' liquidity positions and funding conditions have continued to be favorable on the whole. However, the liquidity positions of small firms and some nonmanufacturing firms are increasingly unfavorable, and therefore developments need to be closely monitored.

Global financial markets have been unstable due to continued disruptions stemming from the U.S. subprime mortgage problem. Although overly pessimistic views about global financial markets have subsided compared with some time ago, the deterioration in the functioning of the U.S. and European markets for securitized products has remained significant and strains in money markets have persisted. Moreover, financial institutions have increasingly been tightening their lending standards. Against this background, the global economy – including the U.S. economy, which has been decelerating even more clearly – has continued to be exposed to downside risk. At the same time, the risk of inflation has been increasing globally, as prices of crude oil and other international commodities have been rising substantially. The Bank considers it necessary to continue to carefully monitor developments in overseas economies and global financial markets as well as the effects of the rise in materials prices.

Regarding prices, the three-month rate of change in the domestic corporate goods price index has been positive, mainly due to the rise in international commodity prices. The year-on-year rate of increase in the CPI (excluding fresh food) has been rising since around the

end of last year, and it has been around 1 percent lately. As for the outlook, it is projected to continue to be positive due to the rise in prices of petroleum products and food products in a situation where overall supply and demand in the economy are more or less balanced. Given that the current increase in the CPI is the highest in 15 years – if we disregard fiscal 1997, when retail prices rose due to the rise in the consumption tax – and that the prices of daily necessities are rising markedly, close attention should be paid to the effects of price developments on consumers' inflation expectations and the price-setting behavior of firms.

II. Conduct of monetary policy and disposal of stocks purchased from financial institutions

As I have explained, the outlook for economic activity and prices is highly uncertain at present. In this situation, the Bank considers that it is not appropriate to predetermine the direction of future monetary policy. Based on a thorough examination of the economic and price situation as well as the market situation both at home and abroad, the Bank will carefully assess the future outlook for economic activity and prices, closely considering the likelihood of its projections as well as relevant risk factors, and will implement its policies in a flexible manner.

The Bank has been appropriately providing liquidity through money market operations. As a result, despite the continued disruptions in global financial markets, Japan's money market has been stable, unlike its U.S. and European counterparts. The Bank will continue to carefully monitor market developments and to ensure, via appropriate money market operations, the proper functioning of the money market.

With regard to stocks purchased from financial institutions through the stock purchasing program implemented between November 2002 and September 2004, the Bank has been disposing of them in the market since October 2007. The book value of the remaining stocks held by the Bank was approximately 1.4 trillion yen as of the end of April 2008.