

## **Masaaki Shirakawa: The recent economic and financial developments and their outlook, and the conduct of monetary policy in Japan**

Summary of a speech given by Mr Masaaki Shirakawa, Governor of the Bank of Japan, to the Naigai Josei Chousa Kai (Research Institute of Japan), Tokyo, 18 July 2008.

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### **Introduction**

I am honored to be invited to speak here today to the Naigai Josei Chousa Kai. As you are all aware, the outlook for the world economy is currently extremely uncertain and policy making has become increasingly difficult. The recent upsurge in energy and materials prices is increasing inflationary pressures globally and, at the same time, putting downside pressures on the economy in many countries consuming these resources. In addition, turmoil in global financial markets stemming from the subprime loan problem in the United States has in no way subsided. Central banks are facing the difficult challenges of maintaining stability in economic activity and prices and also in financial markets.

The Bank of Japan is also facing these challenges. Confronted with downside risks to the economy and upside risks to prices at the same time, which is unusual, the Bank must appropriately steer monetary policy. In addition, given the difficult situation, it is becoming increasingly important for us as policy makers to accurately communicate to market participants and to the general public our assessment of the situation and issues facing Japan's economy. In the first half of my talk today, I would like to discuss the Bank's view on the current situation and the outlook for Japan's economy and then to elaborate on the thinking behind our monetary policy under such circumstances. In the latter half of my talk, I would like to discuss how we are trying to convey our assessment of the economic situation and the thinking behind our conduct of monetary policy, in other words, the role and the framework of communication regarding the conduct of monetary policy.

### **1. Outlook for economic activity and prices and the conduct of monetary policy**

#### ***Current economic situation and the outlook***

I would first like to discuss the current situation of Japan's economy. Since 2002, Japan's economy has enjoyed a moderate but prolonged period of economic expansion. The basic background for the expansion has been the high growth of the world economy, mainly of emerging economies, and the efforts of Japanese firms to restructure their businesses. Although an average of around 2 percent GDP growth between 2002 and 2007 does not seem remarkable, it was somewhat above the potential growth rate and has closed the output gap. Since the end of last year, however, the pace of economic growth has gradually slowed. Initially, this was mainly due to the sudden fall in housing investment reflecting the revision of the Building Standard Law. Subsequently, however, the growth in domestic private demand moderated due to weaker corporate profits and a decline in the real purchasing power of households against the background of the upsurge in energy and materials prices. Given that the sharp rises in energy and materials prices continue to date, it is judged that economic growth is slowing further.

Since Japan relies for various resources heavily on imports, increases in energy and materials prices imply an outflow of income to overseas. For example, relative to early 2002, Japan's export prices have decreased by around 5 percent whereas import prices have risen by around 60 percent, causing a deterioration in Japan's terms of trade. The deterioration in the terms of trade has been especially acute recently. Corporate profits have started to decrease and the growth in corporate fixed investment is slowing. In the household sector,

real purchasing power has decreased since prices are rising while growth in wages remains moderate, and private consumption is becoming somewhat sluggish.

What is the outlook for the future then? As I said at the outset, the environment surrounding domestic and overseas economies is quite uncertain and to make economic forecasts, it has become necessary, more than usual, to carefully consider the most likely outlook, the main scenario, as well as various factors causing uncertainty.

The outlook that we have as the main scenario is that, while Japan's economic growth will likely remain slow for the time being, it is expected to gradually return onto a moderate growth path thereafter without experiencing a deep adjustment phase. There are three reasons for this outlook. First, the robustness of Japan's economy against external shocks has been remarkably strengthened compared with the past. As a result of restructuring efforts during the prolonged adjustment phase after the burst of the bubble, Japanese firms currently face no pressure to adjust production capacity, inventory, or employment. For this reason, the likelihood of any shock triggering a large-scale adjustment seems small. Second, with respect to the financial system, losses incurred by Japanese financial institutions due to the subprime loan problem are limited compared to those of U.S. and European financial institutions and financial markets remain stable. Third, the growth in the world economy, which is providing a favorable environment for Japanese exports, is likely to be maintained. The economic growth rate in emerging economies and countries that export natural resources will likely remain high and it is also relatively likely that the current phase of slow growth in advanced economies will come to an end and the growth rate will gradually recover.

What are the risk factors that may hamper the realization of this main scenario? Two major risk factors could be pointed out. The first is the upsurge in commodity prices and the global increase in inflationary pressures. The second is the developments in global financial markets and in the U.S. and European economies under the influence of the subprime loan problem.

I will first discuss the upsurge in commodity prices, such as prices of energy, materials, and food, and the global increase in inflationary pressures.

The upsurge in commodity prices seems attributable mainly to the sharp increase in demand reflecting high growth in emerging economies and countries that export natural resources, and to the slower growth in production capacity relative to the increase in demand. In addition, speculative or financial factors have been pointed out. Although various factors could be thought to have contributed to the actual rise in commodity prices, it seems possible to attribute the trend increase since 2002 basically to the fundamental factor, which is the condition of supply and demand.

In the 1990s and in the early 2000s, the inflation rates in advanced economies gradually declined with the formerly planned and emerging economies joining the world of the market economies. During this period, the world economy enjoyed favorable economic conditions of high growth, low inflation, and low interest rates with some differences between countries and times. As the process advanced, however, formerly planned economies and emerging economies increased their presence not only as production bases of labor intensive goods but as huge consumers of materials and consumer products. In fact, in 2007 the demand for crude oil declined 0.8 percent for OECD countries, which are advanced economies, whereas it increased 3.9 percent for non-OECD countries.

What began as an upsurge in commodity prices including energy and materials is now leading to an increase in overall inflationary pressures. The headline consumer price inflation rates, which include energy and food, are currently around 4 percent in the United States and the euro area, and have increased around 2 percent relative to a year earlier. The U.S.-type core inflation rate, which excludes energy and food, is over 2 percent. In emerging countries, the inflation rates are much higher: in China, it is around 7 to 8 percent and there are a

number of countries with double-digit inflation rates, such as Russia, Indonesia, and Saudi Arabia.

The fact that inflation rates are increasing worldwide gives rise to the following questions. Was the high world growth during the past several years sustainable? Were sufficient macroeconomic policy measures taken? In fact, the continuance of an extremely accommodative financial environment worldwide has often been referred to as global excess liquidity or a savings glut. However, since the turn of the year, especially during the past several months, an increasing number of countries are shifting their monetary policy in a more restrictive direction. Whether sustainable world growth with price stability is attainable through appropriate macro-economic policy measures applied in various parts of the world has much bearing on the ability of Japan's economy to realize the outlook which I have referred to earlier. But, I must say, every country is confronted with difficult tasks. In the United States, the economy faces with the difficult issues of stagnation, inflationary risks, and the problem in the financial system. In the case of emerging countries, an increasing number of countries are facing the issue of balancing their policy objectives such as sustained high growth and price stability with the management of a de facto fixed foreign exchange system. In any event, the key issue is whether a sustainable pace of world growth can be achieved though with some moderation in the rate of growth.

I will now turn to discuss developments in global financial markets and in the U.S. and European economies, which are the second factor casting uncertainty over Japan's economy. Global financial markets have been unstable as a result of the subprime loan problem. The nature of this problem, however, seems to have evolved over time. In the beginning, the values of various securitized products, including those packaged with subprime mortgage loans, declined. As a result of this, financial institutions incurred large losses and their capital decreased. Confronted with this situation, financial institutions have tightened their credit standards and this has exerted downward pressure on economic activities. Currently, the stage of realizing losses on securitized products has almost been completed. However, reflecting sluggishness in the economy, rates of delinquency on housing loans as well as commercial property loans and consumer loans have been increasing, and the effects of the decline in financial institutions' asset quality on the economy are becoming a concern. It is still not clear when and how the negative feedback loop between capital markets, asset prices, and the real economy will start to move toward resolution in the United States. Apart from the subprime loan problem in the United States, there are cases in other advanced economies where fluctuations in asset prices are exerting adverse effects on the financial systems. With turmoil in global financial markets continuing, downside risks to the U.S. and the world economy continue to be high.

### ***The current state of inflation and its outlook***

I will now turn to the topic of developments in prices in Japan. The twelve-month increase in the CGPI recorded 5.6 percent in June due mainly to the rises in prices of steel and petroleum products. This was the highest rate of increase since February 1981. CPI inflation excluding fresh food had remained around zero until around the fall of last year but started to increase thereafter, mainly due to the rises in petroleum products and food, reaching 1.5 percent in May. Excluding fiscal 1997, when CPI inflation increased reflecting the increase in the rate of consumption tax, this was the largest increase since March 1993. Although it is still low relative to other countries I have mentioned, this is a big change considering the long trend of price stability experienced in Japan.

To examine the outlook for inflation, I would now like to analyze the situation in terms of the three most important factors affecting prices, which are domestic supply and demand conditions, import prices, and inflation expectations of firms and households.

The first factor, domestic supply and demand conditions, is currently more or less balanced. Assuming that the economic outlook to which I just referred is realized, the situation will

remain roughly the same going forward. This indicates that domestic supply and demand conditions are unlikely to be a factor causing a large fluctuation in prices.

The second factor, import prices, has already affected the CGPI and the CPI to a considerable degree through increases in energy and material prices and passing on of such cost increases to sales prices, and it will likely continue to be an important influence.

The third factor, inflation expectations, is theoretically an important factor affecting the inflation rate. The key is whether the increases in energy and materials prices will bring about a "second-round effect" of further increases in wages and prices through heightening of the inflation expectations of firms and households. In fact, after the first oil shock in the 1970s, this "second-round effect" significantly increased prices and led to the situation often called "runaway inflation." So far, the annual increase in wages has remained at around 1 percent and, even considering other data, there seems to be no sign that the "second-round effect" is taking hold in Japan.

Therefore, it is likely that future inflation will depend mainly on developments in energy and materials prices and the degree of pass-on of these cost increases to sales prices. As the main scenario, we assume that CPI inflation is likely to become somewhat elevated in the coming months but gradually moderate thereafter.

However, for the time being, this scenario is not without upside risks that we must be aware of. The major risk is developments in energy and materials prices. We also cannot rule out the possibility of changes in economic agents' inflation expectations, which so far have remained stable. With recent increases in prices of daily necessities such as food, the rate of inflation actually felt by households seems to have shifted upward. According to the Bank's quarterly *Opinion Survey on the General Public's Views and Behavior* conducted in June, more than 90 percent felt that prices have gone up. Since the public's perception of inflation affects the actual inflation rate through inflation expectations and changes in the price-setting behavior of firms, it needs to be monitored carefully along with developments in energy and materials prices.

### ***The conduct of monetary policy***

With this outlook for economic activity and prices as well as the risk factors in mind, I would now like to turn to the subject of the conduct of monetary policy.

Since the termination of the so-called quantitative easing monetary policy in March 2006, the Bank had been conducting monetary policy based on the idea that the level of the policy rate, the uncollateralized overnight call rate, should be raised gradually in accordance with improvements in the economic and price situation. Since the end of last year, however, economic growth has entered a phase of deceleration while the rate of inflation has increased. In addition, uncertainties in global financial markets and overseas economies have heightened. In view of these developments, the Bank is currently taking the stance that future monetary policy should not be predetermined and should be implemented in a flexible manner through careful assessment of the outlook for economic activity and prices, closely considering the likelihood of the Bank's projections as well as factors posing upside or downside risks.

In the current circumstances, what is important is how monetary policy should deal with the so-called "supply shocks," or increases in energy and materials prices. There are two orthodox principles shared by central banks in advanced economies based on their experience of such problems, particularly oil shocks. First, a temporary increase in import costs due to a supply shock should not be dealt with by increases in interest rates. Second, if there is a risk of a "second-round effect" being induced by increases in inflation expectations, it should be dealt with by increases in interest rates. With respect to the ongoing rise in commodity prices, it cannot be taken as "temporary" since it has been continuing for some

time. In addition, the ongoing rise in commodity prices is not only caused by supply-side factors but also influenced strongly by the increases in global demand I referred to earlier.

Therefore, what needs to be assessed in the conduct of monetary policy under the situation of rising import costs could be summarized in the following three points. First is how the influence of two forces working in different directions -- the decrease in domestic demand caused by the outflow of income due to the upsurge in materials prices, and the increase in exports against the background of stronger global demand mainly in emerging economies and countries that export natural resources -- is affecting Japan's economy. Second is how such developments in economic activities will affect price situations. And third is how the increase in commodity prices and the resulting increase in actual inflation is affecting the inflation expectations of households and the price-setting behavior of firms. The conduct of monetary policy in an economic situation like today's is often referred to as "keeping an eye on both the economy and prices." However, this is not a compromise approach of simply balancing both sides. There needs to be a basis of judgment on the conduct of monetary policy when economic activity and prices are displaying irregular developments, and many central banks including the Bank of Japan attach great importance to the third point above, which is whether the stability in the expected rate of inflation is maintained.

The Bank, in light of the monetary policy objective of attaining sustainable growth with price stability, will assess not only the main scenario referred earlier but also the risks of it deviating either to the upside or the downside and conduct monetary policy in an appropriate manner.

## **2. Central bank communication on monetary policy**

So far, I have discussed the outlook for economic activity and prices and the conduct of monetary policy. What is important in conducting monetary policy is the appropriate assessment of economic conditions. If, however, the content of policy decisions and their background are not accurately communicated, there is a risk of monetary policy not fully achieving its intended aims. In addition, independent central banks should be accountable for the basis of their policy decisions as well as actual decisions. Central banks worldwide have been making efforts to improve communication on monetary policy, giving due consideration to the situation in each country, to improve the effectiveness of monetary policy and to be accountable.

At the most recent Monetary Policy Meeting, the Bank decided to adopt several enhancements to its communication strategy on monetary policy. In the latter part of my talk today, I would like to expand a little on the topic of central bank communication.

### ***The contents of communication on monetary policy***

I would first like to discuss three important elements on which the communication on monetary policy is based. The first of these is the objective or the aim of monetary policy. The second is the assessment of the current situation of the economy and prices and the outlook for both. And third is the thinking behind the future conduct of monetary policy.

The first element, the objective of monetary policy, is, in many countries, stipulated in the law governing the central bank as contributing to sustainable economic growth through stability in prices. In Japan, Article 2 of the Bank of Japan Act clearly states that it is "achieving price stability, thereby contributing to the sound development of the national economy." On the other hand, the ways price stability is numerically expressed differ notably from country to country. In the case of the Bank, the level of inflation rate that each Policy Board member understands as being consistent with price stability over the medium to long term is compiled and published as the "understanding of medium- to long-term price stability." The current understanding falls in the range approximately between 0 and 2 percent, with most Policy Board members' median figures at around 1 percent.

The second important element is to communicate the assessment of not only the current situation of the economy and prices but also their outlook. This is because it takes some time for monetary policy to actually affect economic activity and prices. In addition, since the outlook for economic activity and prices always entails uncertainties, it is necessary, when communicating it, to not only present a single scenario, but also to clarify the risks that might result in an upside or downside deviation.

In the case of the Bank, economic and price situations are communicated through means such as the *Monthly Report of Recent Economic and Financial Developments* and the press conference held after each Monetary Policy Meeting. Also in the semiannual *Outlook for Economic Activity and Prices* (Outlook Report), which is published in April and October, projections for the current and the next fiscal year as well as risk factors are published. Starting this April, Risk Balance Charts were introduced to visually express future uncertainties by means of aggregated probability distributions of forecasts of economic growth and inflation by individual Policy Board members.

The third important element is explaining the thinking behind the future conduct of monetary policy. How much this should be explained depends on the economic situation. What is important is that the thinking behind the future conduct of monetary policy depends on the economic and price situation of the time and this should be communicated along with the outlook for economic activity and prices and its risk factors.

In March 2006, the Bank adopted the idea of outlining its assessment of economic activity and prices, which forms the basis of monetary policy conduct, from "two perspectives." In the first perspective, the Policy Board members examine whether the outlook deemed most likely is consistent with the objective of monetary policy, which is the attainment of sustainable growth with price stability, whereas in the second, risk factors that are not captured in the outlook deemed most likely are examined. The Bank, in the light of deliberations from the "two perspectives" described above, outlines its view on future monetary policy, and discloses it in the Outlook Report.

### ***Issues for central bank communication***

In recent years, ways of communicating monetary policy have been actively discussed from the viewpoint of improving the transparency of monetary policy. I would like to discuss a few of these issues facing central banks in the context of the current economic situation.

First is the issue of harmonizing the diversity and transparency of the monetary policy committee. Many central banks, including the Bank of Japan, have the system of decision making by a committee. The final decision on the level of the policy interest rate is made by a majority vote but, in the process, diverse views are expressed on the situation of the economy and prices and the basic thinking behind the conduct of monetary policy. Although this diversity of views is one of the advantages of a committee system, how the central bank's view should be drawn together and released is an important issue.

Second is the issue of how risks and uncertainties should be communicated. Since the transmission lag of monetary policy is long and variable, it is necessary to reveal the outlook for a certain time horizon. Needless to say, uncertainty increases as the time horizon lengthens. In addition, with complex interactions between the monetary and the real sides of the economy, it is usually difficult to anticipate when risks will actually materialize even if they are qualitatively recognized. In the case of the current subprime loan problem, for example, excesses in financial activities and the risk of their reversals had been pointed out quite early by many central banks in their publications such as financial system reports. However, it was impossible to anticipate when it would actually happen. How qualitative and quantitative assessments of the outlook and risk factors should be communicated is an important issue facing central banks.

Third is the issue of how central banks' rationale behind the conduct of monetary policy should be communicated. Some argue that a transparent monetary policy should signal an impending decision to market participants before the next Monetary Policy Meeting. I do not think so. De facto announcement of the future level of the policy interest rate means disregarding the changes in economic conditions after such an announcement. It seems important to communicate the basic rationale behind the conduct of monetary policy with regard to the economic situation of the time.

This also applies to the discussion of inflation rate targeting. Japan not long ago experienced a period of some years of decline in consumer prices. At the time, there was an argument that all available monetary policy tools should be mobilized to achieve the rate of inflation that deemed desirable no matter what the reasons for the decline in prices were. On the other hand, there is an argument today that, confronted with an increase in prices, monetary policy should be conducted disregarding the effects of increases in energy and materials prices. Although there are complex mechanisms behind both increases and decreases in prices, it is an immovable objective of a central bank to assess the basic trend of price developments and achieve sustainable growth through long term stability in prices. If this is not fully understood, the targeted inflation rate will become its own goal and consequently makes the attainment of sustainable growth with price stability difficult.

### ***The recent enhancements to the communication strategy***

As discussed above, there are various issues in terms of improving central banks' communication regarding monetary policy, many of which also apply to the Bank of Japan. With these in mind, the Bank has just gone over its communication strategy to enhance the framework which I described earlier.

The first enhancement is to release the assessment from the "two perspectives" immediately after each Monetary Policy Meeting in the form of a statement. Although we have previously been releasing our basic understanding of the economic situation in the form of "The Bank's View" immediately after the meeting, communication regarding monetary policy had only been an announcement of the decision of "no change" in cases when there was no change in policy. Hereafter, following each meeting, whether or not there is a policy change, a summary of the assessment of the economic and price situation from the "two perspectives," and the Bank's thinking on the future conduct of monetary policy will be published along with the policy decision.

Of course, even under the previous arrangements, the background for the policy decision and the thinking behind the conduct of monetary policy had been communicated very fully at the press conference after the Monetary Policy Meetings. However, from now on the main points will be communicated after each meeting in the form of a statement agreed upon by the Policy Board through discussion followed by a vote during the Monetary Policy Meeting.

The second enhancement is to provide each quarter the forecasts of Policy Board members on the economic growth rate and the inflation rate, and the Risk Balance Charts. Various shocks are always impacting the economy, and there are times when the outlook for the economy and prices needs to be altered. However, if forecasts are revised frequently on the basis of every new item of economic data that becomes available, this will confuse the market. The Bank determined that quarterly publication of forecasts and the Risk Balance Charts is appropriate.

What I must stress here is that forecast numbers and charts are references that supplement the qualitative descriptions in the Outlook Report and the statement that follows each meeting. It would be simple if economic forecasts, which form the basis of policy decisions, could be expressed in one or two figures, but this is not the case, as in all other central banks. The outlook for the economy and prices is too complicated to be expressed in quantitative forecasts and risks. In this sense, qualitative evaluation of the mechanisms behind changes in the economy and prices, and the risks of the deviation from the main

scenario are important. In the Bank's publications, figures should always be read together with the written explanations to obtain a proper understanding.

The third enhancement is to extend the forecast horizon for projections. The forecast horizon for projections in the Outlook Report published in April and October was for two fiscal years, the current and the next fiscal year. Starting from this October, however, the projections in the October Outlook Report will extend to the fiscal year after next. In the case of other central banks, shorter forecast horizons are 1 to 2 years but some extend to around 3 years. The Bank determined that in view of the transmission lag of monetary policy and the uncertainty in the economic outlook, it is appropriate to extend the forecast horizon as above.

I have explained the recent enhancements to our communication strategy. Even if the framework of communication policy is adequate, what decides the quality of communication is the appropriateness of economic analysis and policy decisions. We will continue to make steady efforts to provide appropriate economic analyses, conduct monetary policy based on them, and communicate them carefully.

### ***Closing remarks***

In my remarks today, I have explained the situation of Japan's economy and the conduct of monetary policy, and also our views on central bank communication. My presentation today dealt mainly with monetary policy, but the Bank also plays an important role in an area that may be referred to as banking policy. In the United States, since last summer, the Federal Reserve has been undertaking various liquidity provision measures to maintain stability in the financial system. From our standpoint as a central bank that undertook unusual measures in the face of financial system turmoil from the 1990s, it is surprising that the Bank and the Federal Reserve adopted very similar ways of addressing the situation. Recalling that central banks are originally established to achieve stability in the financial system, however, this is no surprise. It is important for a central bank to actually grasp the situation of individual banks since it is providing credit for them. Also there are various issues regarding actual operation. Credit extension through cross-border collateral, which is currently being discussed among central banks, is one of them. We would like to contribute to the development of Japan's economy by utilizing the full range of functions of a central bank such as stabilizing the financial system and the payment system in addition to conducting monetary policy.

Thank you very much for your kind attention.