

## **Sakuya Fujiwara: Inside a monetary policy meeting**

Speech by Mr Sakuya Fujiwara, Deputy Governor of the Bank of Japan, at Toyo University, 13 March 2003.

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### **Introduction**

I would like to express my gratitude for the opportunity to give this speech.

As you may be aware, my five-year tenure as Deputy Governor of the Bank of Japan is drawing to an end. It is also almost five years since the revised Bank of Japan Law came into effect. The Law was revised comprehensively in 1997, for the first time in its roughly 50 years of existence, in line with a growing trend among central banks around the world to strengthen their autonomy and ensure greater transparency in the implementation of their policies. Previously a journalist, I was appointed as Deputy Governor at a time when the Bank of Japan was to start afresh with the new Bank of Japan Law. It was a truly dramatic change for me. The journalist who had been watching the Bank's policy from the outside, suddenly found himself working inside! Through this, so to speak, switching sides, I discovered many things that were new to me about the Bank. Also, explaining monetary policy, there were many occasions when I was able to gain new insights into the function of the media.

The Bank, as the central bank of Japan, conducts various kinds of business - the best known of which I believe is the issuance of banknotes. Today, based on my five years' experience at the Bank, I would like to talk about the process by which monetary policy is decided in accordance with the Bank of Japan Law of 1997. More specifically, I will talk about what happens in Monetary Policy Meetings (MPMs).

### **I. What is monetary policy?**

First, I would like to briefly explain the basics of monetary policy.

The Bank of Japan Law of 1997 mandates that the Bank's monetary policy shall be aimed, through the pursuit of price stability, at contributing to the sound development of the national economy, making it clear that the objective of monetary policy is to achieve price stability. For the satisfactory development of an economy, it is necessary that resources be allocated efficiently. The competitive market mechanism is a great device to achieve this end. To enable the market mechanism to perform this function properly, one must have a grasp of the trend of prices of goods and services - relative prices, to be more precise - or, from the standpoint of firms, the trend in popular demand for products. A correct assessment of such trends is difficult if the yardstick, prices of goods and services, is not stable. What is more, unexpected fluctuations in prices could cause serious losses to savers or borrowers. This would not be fair, and could also have an adverse impact on the general level of economic activity. This is why price stability is important.

Textbooks on macroeconomics or financial theory explain how central banks try to achieve price stability. Normally, a central bank targets and controls rates in the money market, where transactions take place between financial institutions. In Japan, the Bank guides money market rates through market operations, providing or absorbing funds in the market by buying or selling Japanese government securities and bills. The resulting changes in short-term interest rates gradually affect interest rates on long- and medium-term government bonds, business loans, and deposits. These changes eventually affect the spending of individuals and firms, leading to changes in the supply-demand balance in goods and services. It is through this roundabout process called the transmission mechanism that the Bank tries to achieve stability in prices.

The above textbook theory does not seem to work in Japan's current situation. Due to the prolonged economic slump, money market rates have already fallen to virtually zero percent and thus the traditional practice of easing monetary policy by lowering money market rates is no longer effective. Against this background, the Bank two years ago launched a policy of quantitative easing, shifting the target of money market operations from the overnight call rate to the outstanding balance of current accounts held by financial institutions with the Bank. Financial institutions hold current accounts with the Bank as an instrument of payment as well as to maintain their reserve balances under the reserve requirement system, and the Bank decided to set an operational target for the total outstanding

balance of these accounts. The target amount of the current account balance began at "around 5 trillion yen" and has since been raised a number of times. At present, it is "around 15 to 20 trillion yen." The Bank is thus providing ample funds under this framework of quantitative easing. The aim of this policy is to maintain stability in the financial markets, foster economic recovery, and prevent price falls. The consumer price index (CPI) has been declining at a moderate pace of less than 1 percent year on year. The Bank has announced its intention to prevent further deflation by making a commitment to continue with the policy framework of quantitative monetary easing "until the CPI registers stably a zero percent or an increase year on year."

Recently, there have been lively discussions on the question of the transmission mechanism of monetary policy I mentioned earlier. I will leave detailed explanation of the mechanism for another time, focusing today on explaining the process of monetary policy decision-making. I will try to describe the scene, and the atmosphere in which monetary policy decisions are formulated. I hope it will help to increase your interest in and understanding of monetary policy.

## **II. Who decides monetary policy?**

Japan's monetary policy is determined by the Bank's highest decision-making body, the Policy Board. In this regard, there are two important points to note. First, the Bank is independent from the Government and solely responsible for monetary policy. And second, monetary policy is decided by vote by a policy board made up of nine members.

I will expand on the first point - the Bank's autonomy in its conduct of monetary policy. Why should monetary policy be conducted by an independent central bank? Because policy action that central banks are often pressured to take from a short-term perspective to stimulate the economy could in the medium to long term trigger sharp fluctuations in the economy and prices, putting at risk the sound development of the economy. In the past, there have been numerous instances where increased currency issuance caused hyperinflation. The experience of Japan just before and after World War II is a case in point. These lessons from history gave rise to the belief that monetary policy should be conducted by a central bank that is independent from the government, a system that had won respect over a period of many years in the United States and Germany. Thus, in the 1990s, many countries, both emerging and developed, started to revise their central banking laws to ensure and strengthen their central banks' autonomy. As I explained earlier, the Bank's autonomy was institutionalized in the Bank of Japan Law of 1997, which states that "The Bank of Japan's autonomy regarding currency and monetary control shall be respected." To ensure the independence of the Bank, members of the Policy Board cannot be dismissed for holding opinions at variance with the Government, and the Government cannot order the Bank to undertake any particular policy action.

Needless to say, a central bank should not take advantage of its independent status and act in a self-righteous manner. Moreover, it must strive to clarify to the public the details of and the background to its decisions. This condition is called the accountability or transparency of the central bank in its conduct of monetary policy. The Bank of Japan Law of 1997 contains various provisions to ensure such transparency along with the principal policy objective, which, as mentioned, is to contribute to the sound development of the national economy by maintaining price stability. Furthermore, to ensure that monetary policy is consistent with the Government's basic economic policy framework, the Law states that the Bank should always maintain close contact and exchange views with the Government. As I will discuss later, the Law also allows representatives of the Government to attend MPMs to give their views.

Now for the second point, namely the decision of monetary policy by a committee, or a policy board. At the opposite extreme to this system is the framework in which the final decision is entrusted to the central bank governor, and some central banks maintain this system. However, the majority of central banks currently make use of the system where a committee or members of a board decide monetary policy. The Bank's policy decisions are made through a majority vote of the nine members of the Policy Board, which I believe is an excellent method. This makes it possible for Policy Board members, who share the common objective of contributing to the sound development of the national economy through price stability, to reach the right decisions based on the pool of knowledge and learning of the constituent members. It makes for better decisions and contributes to satisfactory conduct of monetary policy.

### **III. What are MPMs?**

#### **A. *The framework of MPMs***

The Policy Board, which is the Bank's highest decision-making body, discusses a wide range of matters related to the Bank's policy and business operations. Matters related to monetary policy - such as the official discount rate, guidelines and tools for money market operations, and the Bank's assessment of economic and financial developments - are discussed in MPMs. By statute, the procedures for MPMs differ from those of regular Policy Board meetings.

The most important item on the agenda at MPMs is deciding on a policy guideline for money market operations for the intermeeting period ahead. For example, the current guideline for money market operations under the quantitative easing policy framework is as follows: "The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 15 to 20 trillion yen." The Policy Board also determines at MPMs the financial assets the Bank should purchase or accept as eligible collateral. For example, it decided to accept as collateral asset-backed securities (ABS) and asset-backed commercial paper (ABCP), for which there is recently an expanding market.

The Policy Board is composed of nine members - the Governor, two Deputy Governors including myself, and six other members. At MPMs, the Governor and the Deputy Governors independently express their assessment of the economic and financial situation and the conduct of monetary policy. Article 23 of the Bank of Japan Law stipulates that the six members other than the Governor and two Deputy Governors be appointed from "among those with academic expertise or experience including experts on the economy or finance." These members are often mistakenly thought of as working part-time for the Bank, like the members of Government councils who only attend meetings. In fact, they work full-time at the Bank, and perform a wide variety of duties besides attending MPMs, for example, devising measures to maintain an orderly financial system, administering the business operations of the Bank, and strengthening internal management.

Decisions made by the Policy Board are executed by the Bank's staff, comprising the Governor, Deputy Governors, Executive Directors, and other staff.

#### **B. *The schedule for MPMs***

MPMs are held once or twice a month, the first meeting of the month being held over two days. At this meeting, Policy Board members decide a guideline for money market operations for the intermeeting period ahead, and formulate the Bank's view of recent economic and financial developments. The second meeting of the month takes one business day, and Policy Board members review the Bank's decision made at the first meeting.

The schedule for MPMs is released at the end of each quarter for the six months following the month of the announcement.

The Bank of Japan holds meetings on monetary policy more frequently than other major central banks. For example, the Federal Open Market Committee of the U.S. Federal Reserve System has eight regularly scheduled meetings a year. The Governing Council of the European Central Bank meets once a month in principle to decide on monetary policy. The Monetary Policy Committee of the Bank of England holds its meeting once a month.

### **IV. Preparations before MPMs**

Let me describe how the members of the Policy Board prepare for MPMs. Policy Board members are constantly thinking about how to conduct monetary policy in the most effective way, as they are responsible for deciding matters related to the Bank's policy and business operations. Economic indicators are updated every day and conditions in domestic and overseas financial markets also change constantly, and such information provides the basis for monetary policy decisions. Members of the Policy Board assess these data, the results of the staff's research and analysis, and anecdotal information related to firms and financial institutions collected at the Head Office and branches, as well as read a variety of technical and research papers, both domestic and foreign. In addition, members independently gather anecdotal information, and interview and exchange views with market

participants and firms' top management. In this way, Policy Board members gather information related to the overall economy daily.

At MPMs, Policy Board members deliberate on this information gathered through daily research and analysis, and reach a consensus on the appropriate direction for policy. At the meeting, the Bank's staff first present oral reports on the current economic and financial situation. These reports are based on the staff's written reports distributed to Policy Board members at least two business days before the meeting concerned. The written reports include a comprehensive analysis of the economy based on both macro- and microeconomic information obtained during the intermeeting period. The volume of written reports is usually large, and the pages including charts and tables number several hundred. During the two business days prior to MPMs, members read through the staff's written reports and formulate their views on the economic and financial situation and the appropriate direction for monetary policy.

## **V. On the day of the MPM**

### **A. *Members and the staff attending the MPM***

Let me describe what happens in the first MPM of the month, which is held over two business days. The first day of the meeting starts at 2:00 p.m. The nine members of the Policy Board gather in the policy board room at the Bank's Head Office, ready to present their views on the state of the economy and the course of monetary policy. Pursuant to the new Bank of Japan Law, the Minister of Finance and the Minister of State for Economic and Fiscal Policy may, when necessary, attend and express views at MPMs, or they can designate a staff member from the Ministry of Finance or the Cabinet Office to attend the meeting.

Three Executive Directors of the Bank in charge of departments and offices directly concerned with monetary policy, and Directors-General and other senior officials of departments and offices concerned, attend MPMs to present oral reports. Others present at the MPM include the senior official in charge of the Bank's external relations and the staff of the MPM secretariat, which arranges proceedings for MPMs.

### **B. *Presentation of the staff's oral reports on economic and financial developments***

On the first day of the MPM, the staff present reports on recent economic and financial developments. The staff representing the departments and offices concerned report the results of the Bank's money market operations and developments in the economy and financial markets at home and abroad during the intermeeting period. Policy Board members are also updated on new economic indicators as well as the most recent developments in financial markets that have become available since the distribution of the written reports by the staff prior to the meeting. Occasionally, the staff refer to economic indicators released on the actual day of the MPM. In this way, members absorb all information available at the time of the meeting. The staff also answer questions, if any, from Policy Board members after each report.

### **C. *Discussions by Policy Board Members concerning economic and financial developments***

The second day of the MPM starts at 9:00 a.m. The meeting starts with a discussion on economic and financial developments. First, each Policy Board member in turn expresses his or her views on recent economic and financial developments and the prospects for the future, taking into account the oral reports presented by the Bank's staff on the previous day and other members' views.

After all the members have had their turn, they freely exchange views on recent economic and financial developments. During this time, they have further discussions and ask and answer questions and make comments. Let me briefly describe how members' discussions proceed by taking the example of private consumption. First, members discuss typical economic indicators of private consumption, such as sales at department stores, sales of household electrical appliances, and new passenger-car registrations. They also assess, for example, the outcome of winter holiday sales and the effects of unseasonable weather on the economy, taking account of anecdotal information obtained from corporate interviews. They also comment on the outlook for private consumption in

relation to the employment and income situation, since the household income situation basically determines the trend of private consumption. In addition, they assess the effects on private consumption of households' debt burden and developments in asset prices, such as land and stock prices. As you can see from this discussion process, the nine members of the Policy Board assess each type of economic data comprehensively and in depth from various perspectives, and thus a well-thought-out assessment of the economy is formulated.

#### ***D. Deliberations on the conduct of monetary policy***

Policy Board members then discuss the conduct of monetary policy for the intermeeting period ahead, which is the main item on the agenda at MPMs. Each Policy Board member in turn expresses his or her views, mainly on whether the Bank should maintain or change the guideline for money market operations for the intermeeting period ahead, and the reasons. Members also deliberate on the Bank's conduct of monetary policy in the longer term, beyond the next MPM. Occasionally in the discussions, members express their views on financial system problems and the conduct of overall economic policy including fiscal policy.

Members then exchange views freely to gain a better understanding of each other's views and differences in their views. On this basis, members proceed further with the discussion. Through such active discussions, they formulate policy proposals relating to the guideline for money market operations for the intermeeting period ahead.

#### ***E. Remarks by Government representatives***

Next, the Governor, who is the chairman of the Policy Board, provides an opportunity for government representatives to make remarks. As I mentioned earlier, the Minister of Finance and the Minister of State for Economic and Fiscal Policy or their designated delegates can attend MPMs. These representatives can express the views of the Ministry of Finance and the Cabinet Office on the state of the economy, the Government's conduct of economic policy, and the Bank's conduct of monetary policy. In addition, the Bank of Japan Law permits government representatives to request a postponement of the Policy Board members' vote on policy proposals to the next MPM. Government representatives may also submit specific proposals for monetary policy measures to be decided by the Policy Board. In any case, it is up to the Policy Board to decide whether to accept such a request to postpone the vote on the Policy Board members' proposal or to adopt any proposal submitted by government representatives.

Some may say that this system of allowing government representatives to express their views and submit proposals at MPMs threatens the Bank's autonomy. Needless to say, if the Government tried to use this system to impair the Bank's independence in conducting monetary policy, it would be contrary to the Bank of Japan Law. However, the transparency of monetary policy is increased by the framework of MPMs, in which the Government expresses its views on monetary policy at the meetings and the Bank decides on the conduct of monetary policy independently, and by the publication of the decision-making process in the minutes. Therefore, I believe that MPMs provide a very important opportunity for enhancing communication between the Government and the Bank.

#### ***F. Votes***

After thorough discussion, government representatives make remarks, and then Policy Board members take a vote on the proposal relating to the guideline for money market operations. Based on the discussion, the chairman formulates a proposal reflecting the majority view of the Policy Board members. Sometimes other Policy Board members who hold different views submit a proposal separately. A member of the secretariat reads out the proposals, and a vote is taken. The meeting reaches its climax as Policy Board members cast their votes, since a decision on the guideline for money market operations is finally made after an intensive discussion. As mentioned earlier, the proposal is decided by majority vote, and the Policy Board members who have voted against the proposal can state their reasons for opposing it. In this way, the guideline for money market operations for the intermeeting period ahead is decided.

### **G. Decisions on the Bank's view of recent economic and financial developments**

At the first MPM of the month, Policy Board members then discuss "The Bank's View" of recent economic and financial developments, which is published in the Monthly Report of Recent Economic and Financial Developments (consisting of "The Bank's View" and "The Background") on the next business day after the meeting. The draft of "The Bank's View" is formulated based on the Policy Board members' discussion, and the discussion becomes extremely active especially at times when it is difficult to make a definite assessment of the direction of the economy. This is because members attach importance to communicating their assessment of the state of the economy correctly to the public.

In addition, the minutes of the meeting held around one month earlier are approved in the MPM. The schedule for MPMs for the period six months ahead is approved at the last MPM of every quarter.

Policy Board members also approve the release of public statements regarding a decision when there is a change in the guideline for money market operations and when a detailed explanation of the thinking behind a decision is deemed necessary.

The MPM finally comes to a close. The ending of MPMs is timed so that Japanese financial markets can digest the decisions made at MPMs within the day of the meeting as much as possible. At present, MPMs usually end at around 1:00 p.m.

### **H. Press release**

The guideline for money market operations decided at the MPM is released immediately after it ends. After the MPM, the Bank's senior official in charge of external relations quickly enters the Bank's pressroom, where correspondents are waiting. Immediately after the announcement, the media start to report the Bank's decision. Meanwhile, the Bank releases the guideline for money market operations simultaneously in English and Japanese via its Internet Web site. Thus, almost instantaneously, people around the globe can know the Bank's decision.

When there is a policy change, the Governor, as the chairman of the Policy Board, holds a press conference about an hour after the MPM to explain the changes carefully to the public. Even when there is no policy change, the Governor holds a monthly press conference two business days after the first MPM of the month. The Japanese and the English version of "The Bank's View" of the Monthly Report of Recent Economic and Financial Developments and the Japanese version of "The Background" are released on the next business day after the approval of "The Bank's View" at the first MPM of the month. The English version of "The Background" is released on the next business day following the release of "The Bank's View." The minutes of the MPMs are approved at the MPM held around one month after the meeting concerned and released after approval. Transcripts of MPMs are published ten years after the meetings concerned.

### **I. Publication of the Outlook and Risk Assessment of the Economy and Prices (The Outlook Report)**

Now I would like to talk about the Outlook Report, which is a report on the outlook for the economy and prices for the period twelve to 18 months ahead. The Outlook Report is released after it is discussed at the second MPM in April and October. In the report, the standard scenario for Japan's economy and the risk factors that might cause a revision to the standard scenario are explained, and the Policy Board members' forecast of changes in price indexes and real GDP growth rate is included as a reference. At MPMs thereafter, the standard scenario and risk factors in the report are discussed from the longer-term perspective. In short, the report provides a common basis for the members' discussions on the state of the economy.

### **Concluding remarks**

I have attended nearly 90 MPMs during my term of office as Deputy Governor of the Bank of Japan, the post I was appointed to about the same time the new Bank of Japan Law of 1997 came into effect. As a member of the Policy Board, I have taken part in important decision-making concerning monetary policy, such as changing the level of the target of the policy interest rate and implementing quantitative easing measures unprecedented in the history of central banks. When I look back, each MPM was

very intense with active discussion of the Bank's conduct of monetary policy. In concluding my speech, I would like to make three points regarding MPMs based on my five years' experience at the Bank.

First, I would like to emphasize the importance of the framework of MPMs in conducting appropriate monetary policy. As I mentioned earlier, members' discussions are based on all available data on the economy and financial markets reported at MPMs. These data include not only macroeconomic data but also anecdotal information regarding financial institutions and firms. This wide range of information is extremely important in monetary policy decision-making, because the Bank must adjust monetary policy to changes in economic activity and financial markets while at the same time forecasting the likely effect of policy measures in the long term.

Second, transparency of the Bank's conduct of monetary policy has been enhanced by MPMs. I have attached special importance to increasing the transparency of the Bank's decision-making process, having previously been a journalist who had watched the Bank's conduct of monetary policy closely. Given the faster diffusion of information due to progress in IT, a certain degree of confidentiality is required because there is a risk that people might be misled by rumor, which could lead to disruption of financial markets. However, the Bank needs to promptly release its decisions on monetary policy and explain explicitly to the public and financial markets the thinking behind each decision, including its assessment of the economic situation. This accountability in the conduct of monetary policy is an important responsibility of an independent central bank. I have made a special effort to increase the transparency of not only the details of the Bank's decision but also the thinking behind the decision. This is because, if the Bank's thinking and actions are interpreted correctly by market participants, medium- to long-term interest rates will start to factor in future monetary policy, and this will prevent sharp economic fluctuations.

In this regard, the immediate release of decisions made at MPMs, press conferences by the Governor, and the publication of the Monthly Report of Recent Economic and Financial Developments and the minutes of MPMs contribute greatly to enhancing the transparency of the Bank's conduct of monetary policy.

And third, I want to emphasize that there is a very active exchange of views among Policy Board members at MPMs. We often hear criticisms outside the Bank when a decision is reached by unanimous vote at MPMs that there must have been very little discussion at the meeting, or the decision must have already been made prior to the MPM. As a member of the Policy Board, I strongly object to these views. As I have repeatedly said, each member is fully prepared to give his or her views on the economic situation and the appropriate direction of monetary policy before attending an MPM. In the period immediately before a meeting, I concentrate on forming the views that I plan to express by using all available information and holding discussions with the staff of departments and offices concerned. There are frequently cases where members disagree, but this is because they take seriously their responsibility as a Policy Board member devising appropriate monetary policy. Members' remarks and proposals on monetary policy measures made at MPMs are released in the minutes and transcripts of MPMs. Members are therefore under the pressure not only of what they have said being constantly examined by market participants, but also of being judged some time in the future on whether they made the right decision on monetary policy. The Policy Board established under the old Bank of Japan Law of 1942 was once criticized as the "silent Board," where there was very little exchange of views. As you can see, this is not at all true. Since a decision is reached after considerable discussion, members attach significant importance to the decisions made at MPMs and are confident in implementing the measures decided at the meeting.

As I said at the outset, it has been five years since the first MPM was held under the new Bank of Japan Law. We were pioneers at the time, and since then we have steadily improved various aspects of MPMs, such as the way reports are given by staff and the way members' discussions are held. There is no end to this process of improvement, because the framework of MPMs must be enhanced in line with economic and financial developments and the nature of issues that are discussed at them. I have no doubt that the framework of MPMs will continue to be improved by the new Governor and Deputy Governors along with the six other members of the Policy Board to achieve the goal of contributing to the sound development of the national economy through the pursuit of price stability.

Thank you for your attention.