

Toshihiko Fukui: Semiannual report on currency and monetary control

Statement by Mr Toshihiko Fukui, Governor of the Bank of Japan, before the Committee on Financial Affairs, House of Councillors, Tokyo, 21 February 2006.

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Introduction

The Bank of Japan submitted its *Semiannual Report on Currency and Monetary Control* for the first half of fiscal 2005 to the Diet in December 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

The growth of Japan's economy slowed temporarily from the second half of 2004 to the summer of 2005. Thereafter, it emerged from this pause and has continued to recover steadily.

Exports and industrial production have continued to increase. Business fixed investment has continued to increase against the background of high corporate profits. In the household sector, 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 reflecting high corporate profits and the moderate rise in household income, while structural adjustment pressure, such as the excess debt of firms, has almost dissipated. Given that an environment in which a virtuous cycle can start operating has been established with the recovery both in domestic and external demand and in the corporate and the household sectors, the economy is likely to experience a relatively long period of growth, albeit at a moderate pace. Nevertheless, risk factors such as the continuing surge in crude oil prices and its possible effect on overseas economies should continue to be monitored closely.

On the price front, the environment influencing prices has been improving. The output gap has been narrowing moderately, as the economy continues to recover at a pace above its potential. The decline in unit labor costs has been slowing with the increases in wages, despite continued downward pressure from the rise in productivity. Various survey results show that firms' and households' expectations regarding prices are gradually being revised upward.

As for price indexes, domestic corporate goods prices registered the largest increase on a year-on-year basis since March 1990, mainly reflecting the rise in international commodity prices and the depreciation of the yen in the second half of 2005, and are expected to continue increasing. The year-on-year rate of change in consumer prices (excluding fresh food, on a nationwide basis) had been slightly negative, but posted a slight increase for two consecutive months in November and December 2005. The year-on-year rate of change is likely to record a relatively clear increase in January 2006 and thereafter as the effects from the reduction in telephone charges dissipate. A positive trend is likely to be established thereafter, as the output gap continues improving gradually and downward pressures from unit labor costs decrease.

On the financial front, the environment for corporate finance is becoming more accommodative on the whole. The issuing environment for CP and corporate bonds is favorable and the lending attitude of private banks is becoming more active. The decline in credit demand in the private sector is coming to a halt. Under these circumstances, the amount outstanding of CP and corporate bonds issued has been above the previous year's level and the year-on-year rate of increase in the amount outstanding of lending by private banks, after adjusting for the liquidation of loans and loan write-offs, has been accelerating since August 2005 when the year-on-year rate of change turned positive.

Land prices remain generally on a downtrend, but the pace of decline has been slowing recently and in some areas such as central Tokyo they have started to rise.

II. Conduct of monetary policy

The Bank has been providing ample liquidity based on the quantitative easing policy. At the Monetary Policy Meeting on February 8 and 9, 2006, 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 maintain this ample provision of liquidity until the year-on-year rate of change in the consumer price index (CPI) registers zero percent or higher on a sustainable basis.

The effects of the quantitative easing policy have been changing with developments in economic activity and prices as well as the state of the financial system. When there were strong concerns over the stability of the financial system, the Bank's ample provision of liquidity, which met financial institutions' liquidity demand, stabilized financial markets and maintained accommodative financial conditions, and thus contributed to averting a contraction in economic activity.

In the current situation, the financial system in Japan has regained stability mainly because financial institutions have mostly resolved their nonperforming-loan problems, and as a result financial institutions' precautionary demand for liquidity has declined substantially. The year-on-year rate of change in the CPI has become slightly positive recently, and therefore the policy commitment has to a significant extent lost its influence on the formation of longer-term interest rates. Thus, the stimulative effects of the quantitative easing policy on economic activity and prices are coinciding with the effects of short-term interest rates being at practically zero percent.

The effects of monetary easing are being amplified by low interest rates maintained during the improvement in economic and price conditions. Given this situation, the Bank will thoroughly examine economic activity and prices, and decide a change of the policy framework appropriately according to the commitment based on the CPI.

Conclusion

Japan's economy continues to recover steadily. The current economic expansion has lasted four years, since January 2002, based on the Cabinet Office's reference dates of business cycles. This already makes it the third-longest expansion phase in the post-World War II period. As for the outlook, the economy 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. The Bank will also continue to examine the state of the economy in each region thoroughly through such means as research conducted by its branches.

The Bank conducts monetary policy to realize sustainable growth of the economy through the pursuit of price stability. The Bank is determined to firmly support Japan's economy from the financial side to achieve sustainable growth with price stability by maintaining an accommodative financial environment, based on careful examination of developments in economic activity and prices.