

Toshiro Muto: Recent conduct of Japanese monetary policy

Speech by Mr Toshiro Muto, Deputy Governor of the Bank of Japan, at the Yomiuri International Economic Society, Tokyo, 21 July 2006.

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Introduction

At the Monetary Policy Meeting (MPM) held on July 13 and 14, 2006, the Bank of Japan changed the guideline for money market operations and decided to keep the uncollateralized overnight call rate at around 0.25 percent. This was the first policy change since March this year when we abandoned the quantitative easing policy and announced the "Introduction of a New Framework for the Conduct of Monetary Policy."

This action demonstrates that the Bank has returned to pursuing a monetary policy in which it controls interest rates both in name and in deed. Today, I would like to explain the background to the policy change and, by picking up on some key issues, discuss in detail the framework of interest rate control and how its effects feed through into the economy.

I. The current state and outlook for the Japanese economy

A. Sustained economic recovery

The Bank publishes its economic outlook that covers a period of about one year and a half to two years in its semiannual *Outlook for Economic Activity and Prices* (hereafter the Outlook Report). In the April 2006 Outlook Report, we presented our view that, through fiscal 2007, the Japanese economy is likely to experience a sustained period of expansion under price stability. Economic developments since then seem to indicate that the economy is moving broadly in line with this projection.

The expansion of overseas economies is broadening in extent. In the United States, the pace of economic expansion has moderated somewhat, reflecting recent decreases in housing investment and slowing growth in household expenditure and employment. These developments, however, can be seen as part of the process of adjustment toward stable growth. In Europe, the momentum for economic recovery is picking up gradually, as exports and production are growing and household expenditure has also firmed. In China and other newly industrialized countries in East Asia, strong economic expansion is continuing on the back of further progress in the international division of the production process, in terms of both scale and quality, as a result of economic globalization. Against this background of overseas economic expansion, Japan's exports are increasing at a steady pace.

Turning to developments in domestic demand, business fixed investment is showing steady growth. According to the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan), corporate profits have increased for the fourth consecutive year since fiscal 2002 and, taken as a whole, are expected to continue to increase in fiscal 2006, although the influence of higher raw material prices is being observed in some sections of materials industries. Given the increase in corporate profits, business fixed investment plans for fiscal 2006 are displaying high growth, matching the growth recorded in fiscal 2005. This steady growth in business fixed investment is attributable not only to growth in demand at home and abroad and high levels of corporate profits, but also to the dispelling of excess liabilities and a rise in the capital utilization ratio, as well as the increasing obsolescence of existing capital equipment.

The positive effects of favorable corporate profits are being passed through to the household sector. Looking at the employment and income situation, the ratio of job offers to applicants is being maintained somewhat above 1.00, and the unemployment rate has come down to 4.0 percent. Household income remains on a gradual increasing trend, while related indicators suggest that labor market conditions are tightening. Households' expectations regarding the employment and income situation have been gradually revised upward, and as a result consumer sentiment is generally positive.

Some considerable fluctuation has been observed in financial markets since mid-May, as evidenced by the decline in stock prices. Such declines have been seen not only in Japan but in other major as

well as emerging economies, making it a global phenomenon. The adjustment in stock prices may reflect a reevaluation of risk profiles by market participants, as central banks have adjusted the degree of their monetary easing in response to economic and price developments. Also pointed out is growing uncertainty as to whether the world economy, including the United States, will be able to realize steady growth while maintaining a grip on inflation. The swings in financial markets, however, do not seem to imply any significant change in the economic fundamentals underpinning the world economy, which is likely to continue expanding. Nevertheless, we intend to keep a close eye on developments in financial markets and their influence on economic activity, including the economic impact of recently increased geopolitical risks.

B. Changes in price conditions

With the economy experiencing sustained growth, conditions surrounding prices have also improved.

The current phase of economic recovery has already lasted for over four years, and if continued through October, it will match the *Izanagi* boom - to date the longest phase of economic expansion in the postwar era. As a result of this sustained recovery, the estimated "output gap," that is, the difference between actual aggregate demand and the economy's potential supply capacity, is now registering a situation of excess demand. According to the June *Tankan*, the perception among firms of having excess production capacity has dissipated for the first time in some ten years. As for the employment situation, not only is the labor market as a whole less slack but some shortages are becoming apparent, reflecting an improved overall balance between demand and supply.

With the output gap pointing to an excess of aggregate demand over supply, wages are on a moderate upward trend and are expected to rise further in the future. So far, unit labor costs, that is, labor costs required to produce one unit of product, have been dropping substantially on the back of decreasing wages. The result has been a situation in which even when the output gap contracts and excess supply diminishes, this does not feed through into increased prices. Although the growth in productivity is expected to continue putting downward pressure on prices, the decline in unit labor costs is likely to narrow since wages are increasing moderately, and this will eventually lead to a moderate rise in prices.

Given this change in price conditions, various surveys indicate that firms and households are revising their forecasts for prices upward. According to the Bank's *Opinion Survey on the General Public's Views and Behavior*, which asks households to give specific numbers to reflect their expectations of future price conditions, the average of the expected inflation rate for the next five years has increased to 2 percent from around 1 percent in previous surveys.

With respect to price indices, domestic corporate goods prices recorded a year-on-year increase of 3.3 percent in May and June, reflecting higher crude oil and other international commodity prices. This rate of increase surpasses that in early 1990, when the consumption tax was raised, and is the highest recorded since early 1981. The year-on-year rate of change in the consumer price index (CPI; nationwide basis, excluding fresh food) has also been positive since the end of last year, and in the figure for May, the latest available, posted a 0.6 percent increase. Although this reflects the rise in petroleum product prices, the degree to which this factor has been contributing has not increased. Rather, the prices of a growing number of items other than petroleum products are rising, as evidenced in the upward revision seen in some services prices, a phenomenon often observed at the turn of the fiscal year. It is these broader price rises which can be identified as the main factor behind the upward trend in the CPI. The year-on-year rate of change in the CPI is expected to stay positive, as the output gap continues to register excess demand. Although the year-on-year rate of change in the CPI is likely to be revised somewhat downward due to the rebasing of the index in August, the current assessment of a positive rate of price change is unlikely to be affected.

C. Interim assessment of the outlook for economic activity and prices

At the MPM held on July 13 and 14, we examined the current condition of the economy and prices and conducted a midterm review of the outlook for economic activity and prices through fiscal 2007, with a view to assessing whether economic and price conditions are likely to follow the path stated in the Outlook Report. As a result of this examination, we concluded that economic developments are likely to be broadly in line with the outlook described in the Outlook Report. As for prices, the year-on-year rate of change in domestic corporate goods prices in fiscal 2006 is likely to be higher than projected in the Outlook Report, reflecting the rise in prices of crude oil and other international commodities, but in

fiscal 2007 the year-on-year rate of change is likely be around the level predicted in the Outlook Report. The rate of change in the CPI (nationwide basis, excluding fresh food) is expected to stay within the range given in the outlook through fiscal 2007.

II. The aim of the Bank's policy change in July

A. Examination from two perspectives

Let me now describe the aim of the recent policy change in light of the outlook for economic activity and prices.

In March 2006, the Bank introduced the "New Framework for the Conduct of Monetary Policy." At that time, we stated our intention to review economic and price conditions from two perspectives when making decisions on monetary policy. The first perspective involves examining whether the outlook deemed most likely for the economy and prices over the next one to two years is consistent with a path of sustainable growth under price stability. Then, in the second perspective, we examine various risks relevant to the conduct of monetary policy over the longer term, and consider how these may impact on our aim of realizing sustainable growth with price stability.

In terms of the first perspective, Japan's economy is likely to achieve sustainable growth with price stability. However, as I will discuss later, such an outlook presumes that market participants and firms have, to some extent, factored future changes in monetary policy into their managerial decisions. For the economy to develop in line with the projection in the Outlook Report, therefore, some adjustments in the level of the policy interest rate seem necessary. Turning to the second perspective, although no risks of emerging excesses, such as in business fixed investment, have been detected to date, it should be noted that the stimulative impact of the current easy monetary policy is gaining strength along with the steady improvement in economic conditions. Should this impact strengthen further, we may well observe the economic growth rate temporarily deviating significantly above our projection due to accelerated business fixed investment, given that the slack in the economy has already been taken up. In such a case, excess buildup of capital stock may eventually require economic adjustments. In the long run, this would lead to unwarranted fluctuations in economic activity and increase the risk of a large swing in prices.

We also need to carefully watch other risk factors affecting economic activity, such as higher crude oil prices, and their possible consequences for overseas economies. The risk of Japan's economy falling back into a vicious cycle of deflation and deteriorating economic activity, however, seems smaller than before given the return of stability and confidence in the financial system and the dispelling of excesses in the corporate sector, namely, in capital stock, labor holdings, and levels of debt. In the late 1990s, after the bubble era, Japan's economy experienced two recovery phases, which were derailed by external shocks. The recessions that followed were deep. In hindsight, the depth of these recessions could well have been aggravated by excess holdings of capital stock, labor, and debt in the corporate sector as well as the fragility of the financial system - the other side of the same coin - all of which exert downward pressure on the economy. During the current recovery phase, however, economic recession has not occurred, although temporary losses of recovery momentum have been seen. In the summer of 2004, for example, adjustments in IT-related industries caused the economy to enter a soft patch which lasted for nearly a year. Eventually, however, the economy regained its recovery momentum. Such incidents suggest that the current recovery phase is quite different from its predecessors in the 1990s, exhibiting greater durability in the face of shocks.

B. Change in the guideline for monetary market operations

At the MPM held on July 13 and 14, the Bank decided to change the guideline for its money market operations in the intermeeting period to "encourage the uncollateralized overnight call rate to remain at around 0.25 percent." We judged, after examining the economic and price situation from the two perspectives outlined above, that an adjustment in the interest rate level was appropriate in order to keep the economy on a desirable path. Such a change, in our view, will contribute to ensuring price stability and achieving sustainable economic growth in the medium to long term.

This policy change was made on the basis of an economic and price forecast, which remained unchanged from the April Outlook Report, and in line with the basic thinking governing the conduct of monetary policy stated in it. We will continue to conduct monetary policy based on the careful

examination of economic and price conditions. More specifically, if the economy is likely to follow the path projected in the Outlook Report, then this will entail some gradual adjustment in the level of the policy interest rate so as to accommodate the ongoing changes in economic and price conditions. Such being the case, it is likely that an easy monetary environment with extremely low interest rates will be maintained for some time. The Bank's basic thinking in this regard has been emphasized repeatedly, but simply put, we intend to adjust the level of interest rates gradually, taking careful account of developments in economic activity and prices.

In line with the policy change, we have decided to raise the basic loan rate offered under the complementary lending facility to 0.4 percent. The interest rate differential between the basic loan rate and the operating target of the uncollateralized overnight call rate has widened marginally from the previous 0.10 percent to 0.15 percent. Generally speaking, the smaller this differential, the less likely the uncollateralized call rate is to diverge from the Bank's operating target. At the same time, however, a smaller differential is also likely, to some extent, to restrict the free formation of market interest rates. Recently, the situation in the money market has been somewhat restrictive from the standpoint of the free formation of interest rates: a consistently large amount of lending has been taking place through the complementary lending facility, mainly reflecting high repo rates. On the other hand, the functioning of the money market, which has been in the process of recovery since the abandonment of the quantitative easing policy in March, has not yet been fully restored, so that some smoothing of the fluctuations in the call rate was still deemed to be necessary. On balance, therefore, we decided to keep the changes to the interest rate differential between the basic loan rate and the operating target of the uncollateralized overnight call rate as small as possible because we thought that, while also giving consideration to the principle of the free formation of interest rates, our priority should be to control the call rate in a stable manner.

III. Interest rate control and its transmission

A. Control of short-term rates

As stated above, our current guideline for money market operations is to "encourage the uncollateralized overnight call rate to remain at around 0.25 percent." Under the framework of the quantitative easing policy in place until March this year, our main operating target was a "quantity," namely, the outstanding balance of current accounts that financial institutions hold at the Bank. For example, the guideline for money market operations set forth at the MPM in February this year was to "conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen."

At central banks in leading industrial nations, monetary policy is conducted by controlling money market interest rates at the very short end. It is also quite common for these central banks to set a target for such money market rates or to set the base rate for their money market operations as the "policy interest rate," thereby leading the money market to achieve the target or the base rate. Since the abandonment of the quantitative easing policy in March this year, the uncollateralized overnight call rate, which is a rate used in trading overnight funds among financial institutions, has been the Bank's operating target for its money market operations. In other words, after a lapse of five years, implementation of monetary policy at the Bank of Japan has finally come back into line with that of other central banks in leading economies.

B. The money market and interest rate arbitrage

In connection with the Bank's return to an interest rate policy, let me take the opportunity to discuss, over a rather longer-term perspective, the framework of interest rate control and the mechanisms by which it is transmitted.

The Bank conducts money market operations as a participant in the market. While the bond and stock markets serve as venues for trading long-term funds or capital, the money market is characterized by the trade for short-term funds. Money markets are normally defined as markets where funds with maturities of less than a year are traded. They are sometimes classified according to the nature of their participants: the interbank market is so called because its participants are limited to financial institutions, while the open market's participants also include firms and local governments. The call market is an interbank market where short-term funds are traded among financial institutions so as to clear their daily excesses or shortages of funds. The call market is further subdivided into the

uncollateralized and collateralized call markets, according to the collateral requirements for trading. Examples of open markets include the bond *gensaki* market, the repo market (for the lending/borrowing of Japanese government securities against cash collateral), the certificate of deposit (CD) market, the commercial paper (CP) market, the treasury bill (TB) market, and the financing bill (FB) market.

The Bank controls interest rates by conducting daily money market operations where it buys and sells financial instruments such as bonds through competitive auctions, thereby adjusting for excesses or shortages of funds in the money market that may arise, for example, from changes in the supply of banknotes and public funds. The interest rate assigned as the target in such an operation is the uncollateralized overnight call rate. The Bank's conduct of monetary policy begins with this exertion of control over the uncollateralized overnight call rate, and this is then conveyed through interest rate arbitrage to other rates in the money and bond markets as well as on deposits and loans, thus eventually coming to affect economic activity as a whole.

C. *How the change in the money market interest rate is conveyed to medium- to long-term interest rates*

The mechanism by which a very short-term market interest rate, such as the uncollateralized overnight call rate, is transmitted through to interest rates at the longer end of the market is based on the idea that medium- to long-term interest rates are constructed as an average of expected short-term interest rates during the period concerned, plus a risk premium covering uncertainty. The implication is that while the central bank tends to determine a very short-term interest rate in accordance with the economic and price situation, medium- to long-term interest rates are determined by market participants' expectations concerning the future evolution of economic activity and prices, the central bank's monetary policy response to these developments, and the appropriate size of the risk premium given the level of uncertainty in the economy.

Medium- to long-term interest rates determined in this way reflect market projections of the future path of short-term interest rates. Monetary policy does not directly control the yield curve, a curved line that indicates the relationship between interest rates and maturities; rather, the yield curve is shaped by the term structure of interest rates, which incorporates market participants' expectations regarding the central bank's future policy decisions. Ultimately, it is the shape of the yield curve that actually influences the economic decisions of firms and households.

It is important to control the anticipated path of the short-term interest rate, but this does not mean that the Bank can always keep medium- to long-term interest rates low by setting the path of short-term interest rates low and by communicating this to market participants. This is because, in the long run, the future path of the policy interest rate needs to be in line with the economic and price situation. If a policy interest rate is continuously set too high or too low relative to economic and price conditions, this will have an adverse impact on the economy and prices, which will eventually require a significant rise or reduction in the policy interest rate by the central bank. If market anticipation of such unnecessary fluctuations in interest rates increases uncertainty, the risk premium will become larger, thereby causing medium- and long-term interest rates to shift further upward.

It is sometimes said that long-term interest rates reflect people's view of future economic and price conditions, and they cannot therefore be controlled by monetary policy. Long-term interest rates are in fact influenced by a change in monetary policy, but for the reasons outlined above, the central bank cannot force them out of line with underlying economic and price conditions. If monetary policy is conducted in line with economic and price conditions, and market participants are confident that this will be the case, the risk premium will become smaller, providing a firm basis for long-term interest rate stability.

D. *Influence on economic activity*

Let me now turn to the influence of a shift in the yield curve on economic activity. There are actually several routes by which this impact is felt. One route involves influencing investment activity by altering its profitability. As I have stated, the effects of changes in the policy interest rate are passed onto interest rates in various financial markets as well as deposit and loan rates. From the standpoint of firms and households, funding rates change in line with a change in the policy interest rate, and this will affect their decisions to invest in equipment and housing. Another possible route operates via changes in foreign exchange rates affecting either the profitability or the volume of exports. Changes

in the domestic interest rate affect nominal foreign exchange rates through, for example, arbitrage between domestic and overseas interest rates. The resultant movements in nominal foreign exchange rates will alter competitiveness in export industries, thereby affecting either the profitability or the volume of exports. A third route operates via changes in asset prices influencing investment and consumption behavior. With the ongoing accumulation of financial assets in recent years, changes in equity and land prices are thought to have a greater impact on the spending behavior of firms and households. Finally, other routes such as changes in interest rate returns affecting corporate profits are also important.

These routes describe how changes in the shape of the yield curve feed through into changes in economic activity. When economic agents such as firms and households make investment decisions, they naturally take into account potential risks. These risks vary with the investment horizon, which will be reflected in the maturity of the financial instruments selected to fund the investment. The further ahead firms and households are required to look into the future, the larger the influence of changes in medium- to long-term interest rates upon their investment decisions. Furthermore, since the market expectations concerning the future outlook for the economy and prices as well as the policy response of the central bank form the basis of medium- to long-term interest rates, these market expectations become particularly important.

IV. Issues related to interest rate control

A. The significance of the "official discount rate"

So far, I have discussed the basic framework of interest rate control and its paths of transmission. I would now like to turn to some issues related to interest rate control. There are three key issues here: the significance of the "official discount rate," the importance of expectations formation, and the transmission lag following monetary policy actions.

Let me start with the significance of the "official discount rate," which is the rate the Bank applies when lending directly to financial institutions. The "official discount rate" is probably one of the most familiar terms used in association with monetary policy. However, it is in fact not prescribed in the Bank of Japan Law. The term "official discount rate" was used to refer to two rates specified within the Bank of Japan Law, namely, the "basic discount rate" and the "basic loan rate." In the past, these rates were prescribed under two separate categories as the "Discount Rate of Commercial Bills and Interest Rates on Loans Secured by Government Bonds, Specially Designated Securities and Bills Corresponding to Commercial Bills" and the "Interest Rates on Loans Secured by Other Collateral," and they were set separately. In 2001, these two categories were combined into a single rate termed the "Basic Discount Rate and Basic Loan Rate."

During the days of regulated interest rates, the "official discount rate" was the policy interest rate typically used to express the basic stance of monetary policy. In those days, various interest rates were linked to the "official discount rate" and changes in the "official discount rate" directly affected deposit and lending rates. A change in the "official discount rate" was considered to constitute a change in the basic stance of monetary policy and thus to have a so-called "announcement effect." In 1994, however, the liberalization of interest rates was completed and the systematic linkage between the "official discount rate" and deposit rates diminished. Currently, all interest rates are determined by arbitrage in the market, as I explained earlier, and not by systematic linkage. As a result, the role of "official discount rate" has shifted to the rate offered under the complementary lending facility - a loan facility, introduced in 2001, through which the Bank extends loans at the request of counterparties subject to conditions pre-specified by the Bank - and this now effectively stands as the *de facto* upper limit on the overnight call rate. Importantly, however, the current policy interest rate is the uncollateralized overnight call rate and not this "official discount rate." For this reason, we think it appropriate to use the term "basic loan rate" or "rate offered under the complementary lending facility" in preference to "official discount rate," which has tended in the past to be associated with the policy interest rate.

B. The importance of expectations formation

Let me now discuss the importance of expectations formation.

I have just explained how economic agents' expectations concerning the future path of the policy interest rate influence economic activity and hence developments in prices. The implication is that the impact of monetary policy can be more effectively increased by influencing market expectations regarding future policy than by independently raising or lowering interest rates. If a change in short-term interest rates is considered merely temporary, it will not alter the level of medium- or long-term interest rates, and its overall influence on the economy will be limited. On the other hand, if market participants form expectations that a change in short-term interest rates will be long-lasting, medium- to long-term interest rates will respond accordingly, thereby increasing the overall impact on the economy.

When expectations are formed about future changes in short-term interest rates and these are fully incorporated in the formation of medium- to long-term interest rates, a number of points are relevant. First, the intended effect of a policy change is achieved as soon as it is anticipated, rather than at the point when it is actually enacted. If a fully anticipated future policy change is incorporated in the shape of the yield curve, firms and households will take the change as given and make their consumption and investment decisions accordingly. Second, medium- to long-term interest rates will not change substantially at the actual enactment of the policy change. The idea that a substantial policy impact can only be achieved if the policy takes the market by surprise and causes a sudden large shift in medium- to long-term interest rates is fundamentally flawed. If the policy change is fully incorporated in market expectations, it may seem as though its actual enactment by the central bank is merely following the market. However, this should be taken as evidence that monetary policy is being conducted credibly and transparently, with economic agents such as firms and households behaving accordingly. And third, even if a policy change has already been incorporated into market expectations and its effect achieved, this does not mean that it is no longer actually necessary to enact the change. Should the market expectations be disappointed, this will affect perceptions of future monetary policy, thereby changing the shape of the yield curve.

Given the relationship between expectations formation and the yield curve described above, the central bank should seek to improve transparency by carefully explaining its assessment of the state of the economy and financial developments, and ensuring that the formation of the yield curve will be consistent with its thinking regarding the conduct of monetary policy by laying out the latter clearly. With this in mind, the Bank has been communicating with the public through the release of, for example, the Outlook Report, the Minutes of the MPMs, the *Monthly Report of Recent Economic and Financial Developments*, press conferences, and speeches, as well as by enriching the content of its web site. As a result, the Bank is now probably one of the heaviest suppliers of information among central banks. The point here is that ensuring the transparency of monetary policy is not just about accountability, but also about raising the effectiveness of monetary policy. Needless to say, central banks do not follow the market when the market expectation of a policy change is deemed erroneous. In such cases, the central bank will seek to adjust market expectations by communicating to the market its assessment of economic conditions and its views on the appropriate conduct of monetary policy.

Bearing this in mind, it is useful to incorporate an expected future change in the policy interest rate and its anticipated influence on the economy into the outlook for economic activity and prices that the central bank makes public. In the past, the Bank's outlook for economic activity and prices was based on the assumption of a "fixed monetary policy," in other words, it hypothesized that its monetary policy would be unchanged. Since the April 2006 Outlook Report, however, the Bank's outlook for economic activity and prices has been produced taking account of forecasts of the future policy interest rate embodied in market interest rates, instead of assuming that the policy interest rate will remain unchanged. A number of other central banks that publish an economic and price outlook, such as the Bank of England (BOE) and the European Central Bank (ECB), have started to use market participants' projections of the policy interest rate as the assumed policy interest rate when producing their outlooks.

C. Transmission lags

Lastly, I would like to take up the issue of the so-called transmission lag, the time lag between a monetary policy action and its impact on the economy.

It takes a certain amount of time for the effects of a monetary policy action to filter through into the economy and prices. Among the various transmission channels mentioned earlier, the effects of a change in interest rates on expected rates of return on investment may be felt within a relatively short

period of time. Transmission through foreign exchange rates and asset prices may also take place swiftly. It takes time, however, for an interest rate change to affect household income through corporate profits. Considerably more time is then required for a change in corporate profits and household income to gradually alter firm and household sentiment and hence impact on consumption and investment decisions. For a policy change to be fully transmitted through to the economy, therefore, requires a considerable amount of time even when firms and households are rational and forward-looking. There are then still further lags between the change in the economic situation and the eventual impact on prices.

It is such lags in policy transmission that necessitate a forward-looking approach to conducting monetary policy. For policy actions to be effective, it is necessary to act based on the outlook for economic activity and prices over a sufficiently long term. In the *Quarterly Bulletin* of the BOE, for example, the economic and price outlook of Monetary Policy Committee members for the next three years is produced and published. At the ECB, the staff release their outlook for the economy and prices over the next two years. Behind the time frames of these reports lies the idea that the transmission of monetary policy through to the economy takes place with a long lag.

Furthermore, the length of the lag differs substantially not only depending on the structure of the economy but also depending on other factors such as the phase of the business cycle. For this reason, producing accurate economic and price projections that incorporate the transmission lag is no easy task. In recent several years, especially, productivity growth and wage restraint in the corporate sector have made prices less sensitive to economic recovery. The situation has, so far, contributed favorably to economic developments, in the sense that economic expansion has been relatively compatible with price stability. Viewed from a medium- to long-term perspective, however, the implication is that short-term projections of inflation will prove inadequate as guideposts for steering monetary policy toward price stability and that past relationships between economic conditions and prices will no longer hold. It is, therefore, becoming more important to act with appropriately increased sensitivity to risks affecting economic activity and prices over longer horizons.

Concluding remarks

I have so far explained the background to the recent change in the Bank's monetary policy and discussed in some depth issues related to interest rate control and the path by which its effects are transmitted to the economy.

Let me raise one important point before I conclude. That is, for the effects of monetary policy to filter through into the economy in the way I have discussed today, both financial markets and financial institutions have an important intermediary role to play. Strengthening the monetary policy transmission mechanism by improving the functioning of various financial markets and financial institutions is also very important in supporting the infrastructure of a dynamic Japanese economy in the long run. In this regard, the Bank has been encouraging the fostering and growth of market transactions geared toward improving the functioning of the financial markets. Improving the practice of money market operations, the introduction of a next-generation real-time gross settlement system, and the improvement of business continuity plans in times of disaster are some examples. We, along with market participants, intend to strive to further improve the functioning of financial markets. As for enhancing financial institutions' performance of their intermediary functions, we will be working toward creating an environment where financial institutions, through discussions during on-site examinations or interviews, are able to build new business models and upgrade frameworks for risk control, as well as to improve management and internal control systems so as to allow monetary functions to operate efficiently.

The Bank would like to contribute, through such efforts, to achieving sustainable economic growth in Japan under price stability.

Thank you very much for your attention.