

Toshihiko Fukui: Overall review of the Bank of Japan's conduct of monetary policy

Statement by Mr Toshihiko Fukui, Governor of the Bank of Japan, concerning the Bank's Semiannual Report on Currency and Monetary Control, before the Committee on Financial Affairs, House of Councillors, Tokyo, 31 October 2006.

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Introduction

The Bank of Japan submitted its *Semiannual Report on Currency and Monetary Control* for the second half of fiscal 2005 to the Diet on June 9, 2006. I am pleased to have this opportunity to present an overall review of the Bank's conduct of monetary policy.

I. Developments in Japan's economy

Japan's economy is expanding moderately.

Exports have continued to increase due to the expansion of overseas economies. Business fixed investment has also continued to increase against the background of high corporate profits and favorable business sentiment. The positive influence of the strength in the corporate sector has been feeding through into the household sector. While firms have been increasingly feeling a shortage of labor, the number of employees has been increasing steadily and wages have also been rising gradually. In this situation, private consumption has been on an increasing trend. With the rise in demand both at home and abroad, production has been increasing, and inventories have been more or less in balance with shipments.

Looking forward, Japan's economy is likely to experience a sustained period of expansion with a virtuous circle of production, income, and spending in operation.

There are various risks concerning future developments in Japan's economy. For example, although international commodity prices, primarily crude oil prices, have declined since posting record highs this summer, they still remain at high levels. In this situation, whether the world economy can maintain sustainable growth while containing inflationary risks continues to warrant attention.

On the price front, domestic corporate goods prices have been increasing recently. However, the pace of increase is expected to slow in the immediate future, due to the recent drop in international commodity prices. The year-on-year rate of change in the consumer price index (CPI; excluding fresh food) has been on a positive trend, although retroactive revisions following the rebasing of the index caused the figure to be revised downward. The output gap is positive and is likely to widen at a moderate pace going forward. Under these circumstances, the year-on-year rate of change in the CPI is projected to continue to follow a positive trend.

As for financial conditions, the environment for corporate finance has been accommodative. In the corporate bond and CP markets, the issuing environment has been favorable. Private banks have been maintaining a proactive lending posture. Credit demand in the private sector has been rising and the amount outstanding of lending by private banks thus has continued to increase.

II. Conduct of monetary policy

The Bank terminated the quantitative easing policy in March and raised the uncollateralized overnight call rate target from effectively zero percent to around 0.25 percent in July. For the first time in about five years, interest rates in the money market are again above zero, and the market mechanism has started to function again. Despite such a significant change in the environment, financial markets have remained stable. A factor that contributed to the smooth policy shift was that the new framework for the conduct of monetary policy, which the Bank introduced in March when it terminated the quantitative easing policy, functioned effectively as a means of communicating with market participants and the public.

Regarding the future path of monetary policy, the Bank will conduct monetary policy by carefully assessing economic activity and prices under the new framework. If developments in economic activity and prices follow the Bank's projection presented in the Outlook Report, the Bank will adjust the level of the policy interest rate gradually in the light of these developments. Of course, the timing of any policy change and the level of interest rates will also depend on these developments. The Bank is determined to conduct monetary policy appropriately in the light of developments in economic activity and prices, and contribute to sustainable economic growth under price stability.