Masaaki Shirakawa: Recent economic and financial developments and the conduct of monetary policy

Summary of a speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, to the Japan National Press Club, Tokyo, 12 May 2008.

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Introduction

I am honored to be invited to speak here today to the Japan National Press Club. The club has been called "traditional" in the sense that it is valued for its long history, but it is also known for its tradition of asking speakers tough questions. I once heard from a senior colleague at the Bank of Japan that the governor of a central bank can deliver a speech here only when the economy is performing satisfactorily and he or she is fully confident about the conduct of monetary policy. I am here today to deliver my first speech since being appointed as the Governor of the Bank, not because this is the case, but because I hope your forthright questions will provide me with food for thought and also because this is a good opportunity to explain the Bank's thinking behind the conduct of monetary policy.

In the first half of my speech, I will talk about the current situation of and outlook for Japan's economy and the conduct of monetary policy in the near term. In the second half, I would like to explain some basic points that I believe are important for the conduct of monetary policy.

I. The outlook for economic activity and prices and the conduct of monetary policy in the near term

A. The current situation of and Outlook for Economic Activity and Prices

I will first explain the current situation of and outlook for Japan's economy. At the Bank's Monetary Policy Meetings, or MPMs for short, the Policy Board members discuss the outlook for economic activity and prices. At the MPMs held at the end of each April and October, they center their discussion on the outlook for the coming two years. Based on that, the Bank makes public its thinking behind its conduct of monetary policy in the *Outlook for Economic Activity and Prices*, or the Outlook Report. In the Outlook Report released at the end of April this year, the Bank revised its economic assessment downward from the previous Outlook Report released six months ago, stating that Japan's economic growth was slowing and that deceleration in the economy seemed likely to continue for the time being.

The first cause of the slowdown in the economy is the rises in energy and materials prices. The deterioration in the terms of trade that results from such rises leads to a decline in real income, as Japan depends heavily on imported resources. This exerts downward pressure on corporate profits and reduces households' purchasing power, eventually resulting in a decrease in investment and consumption. The second cause is the disruptions in global financial markets and the growing uncertainty regarding overseas economies stemming from the U.S. subprime mortgage problem, which arose last summer. In a situation where concerns exist about the uncertainty of the economic outlook, business sentiment has become cautious – as is evident, for example, in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) – and consumer sentiment has also deteriorated. Since the effects of these two causes are likely to persist, deceleration in the economy seems likely to continue for the time being.

Thereafter, however, the economy is likely to return to a moderate growth path, as overseas economies are expected to move out of their deceleration phase and the effects of the rises in energy and materials prices are likely to abate. Expressing the outlook numerically, from fiscal 2008 through fiscal 2009, the economy is likely to grow at a pace around the potential growth rate, which is estimated to be 1.5 percent or somewhat higher.

This view is supported by the following facts. First, overseas economies, especially emerging economies, are likely to continue to grow at a relatively high rate, although the pace of growth is likely to decelerate slightly. Japan's exports have remained firm as a whole – even though those to the United States have been falling for some time – as they have been increasing at a considerable pace to a broader range of destinations, particularly emerging economies and countries that export natural resources. Japan's exports are expected to continue rising against the background of the rapid growth of these economies. Second, although economic activity might weaken further, it seems that Japan's economy has become more resilient to negative shocks than in the past. In the corporate sector, firms currently face no excess in production capacity, inventory, or employment, and corporate profits have been close to historical highs. As a result of this, Japanese financial institutions are very sound. And third, the accommodative financial conditions are likely to continue to support private demand. Given that currently the uncollateralized overnight call rate is 0.5 percent and the year-on-year rate of change in the CPI is slightly above 1 percent, the short-term real interest rate is in rough terms 0 percent. The level is very low relative to the potential growth rate, and is also low compared with that in other major economies. Credit spreads, which are added to benchmark interest rates when firms borrow funds, have not been increasing either, unlike in Europe and the United States. Moreover, financial institutions' lending attitudes and firms' liquidity positions have continued to be favorable on the whole, although the situation for small firms has been relatively severe.

Turning to prices, the year-on-year rate of increase in the CPI excluding fresh food has been rising since around the end of 2007 due mainly to increased prices of petroleum products and food products, and was 1.2 percent in March 2008. The rate was the highest increase in the 15 years since August 1993, if we disregard fiscal 1997, when retail prices rose due to the rise in the consumption tax. A major factor that affects inflation is the balance between aggregate supply and demand in the economy, or the level of resource utilization in terms of the labor and production capacity. On this point, the level of resource utilization is currently close to its historical average judging from firms' perception of employment conditions and production capacity as seen in the *Tankan*, as well as from the unemployment rate and the capacity utilization rate. Assuming that the economy grows at around the potential growth rate as I have described, aggregate supply and demand in the economy are likely to remain more or less balanced. Therefore, the supply-demand balance in the domestic economy is unlikely to significantly affect CPI inflation either upward or downward. However, a process is likely to take place in which the rise in energy and materials prices will gradually be passed on to downstream prices, and thus CPI inflation is projected to be around 1 percent for both fiscal 2008 and fiscal 2009.

CPI inflation of around 1 percent is consistent with the Bank's "understanding of medium to long-term price stability" and it is where most Policy Board members' median figures of ranges that they understand as being consistent with price stability over the medium to long term are located. Therefore, future developments in the CPI may also be assessed as being within the range of "price stability." In this regard, the price situation in Japan is favorable as compared with major overseas economies, where the inflation rate has been very close to or above the upper limit of the range regarded as consistent with price stability. However, inflation perceived by households in Japan may in fact be higher than the rate of change in the CPI, as suggested by many survey results – for example, the Bank's *Opinion Survey on the General Public's Views and Behavior* – given that prices of goods that are purchased frequently, such as food products, have been rising noticeably. I think that the Bank should pay close attention to changes in people's perception of inflation, since they may affect the actual rate of change in prices through, for example, consumers' expected inflation rate and firms' price-setting behavior.

B. Uncertainty regarding the Outlook for Economic Activity and Prices

In the Bank's most likely projection, or the baseline scenario, it is projected that the growth rate of Japan's economy will decelerate for the time being but thereafter the economy is likely to continue its moderate growth with price stability. However, as I will discuss in a moment, an economic outlook is always subject to uncertainties, and currently the situation is one where the degree of uncertainty is especially high. In such a situation, it is necessary to thoroughly and closely assess not only the baseline scenario but also the possibility of the economy deviating either upward or downward from it, that is, the risk scenarios.

The first risk to the outlook concerns developments in overseas economies and global financial markets. Disruptions in global financial markets have continued for over six months. In a speech made in early April, Federal Reserve Chairman Ben S. Bernanke said, "I think it is true that the financial distress we are seeing now is among the most severe episodes of the postwar era," and my view is exactly the same. Issuance in markets for securitized products, where the U.S. subprime mortgage problem originated, has been brought to a halt. Looking at corporate finance in the United States and Europe as a whole, credit spreads such as those on corporate bonds have been large. U.S. and European financial institutions have increasingly tightened their lending standards.

Amid the tightening of the financial environment, in addition to the drop in housing investment, deceleration in the U.S. economy is becoming more pronounced. It is highly likely that, for the time being, the U.S. economy will experience sluggish growth, or even a moderate recession. The timing and pace of recovery of the U.S. economy will largely depend on when the housing market correction is completed and when the financial environment stops deteriorating. An improvement in the housing and financial markets, in combination with the reductions in the policy interest rate by the Fed and a fiscal stimulus package, will make it more likely that the U.S. economy recovers gradually. However, home prices have yet to stop declining, and there are no signs that the financial market disruptions will abate. In addition, there are risks of a further tightening of financial institutions' lending attitudes. The key is when and how the combined effects of disruptions in financial markets, asset prices, and economic activity will diminish, which is unforeseeable, and this is the biggest source of uncertainty.

The second risk concerns developments in energy and materials prices. In the outlook that I described earlier, it is projected that the prices of crude oil and other international commodities will remain elevated, supported by growing demand especially in emerging economies. Considerable uncertainty always surrounds developments in these prices, leaving the potential for movement in either direction. If the rise in international commodity prices is significantly faster than expected, this could further increase inflationary pressures around the world. In that case, there would be a risk of a subsequent economic slowdown through the monetary tightening aimed at preventing inflation. As for the effects on Japan's economy, higher prices of international commodities would not only accelerate inflation but also increase the outflow of income, and this might put downward pressure on the economy.

As I have described, there is considerable uncertainty, especially about developments in overseas economies and global financial markets and also high prices of energy and materials, and attention should be paid particularly to the downside risks to Japan's economy.

However, it should be borne in mind that everyone, including policymakers, tends to be strongly affected by the current situation when forecasting the future. We should, considering the matter calmly, be aware that the significance of the upside risks will increase if the dense fog surrounding the outlook for the global and Japanese economies gradually clears. It seems that, for the time being, downside risks, rather than upside ones, are likely to be incorporated into the decision-making of households and firms. Nevertheless, it seems that their expectations of future growth in the somewhat longer term are being maintained. In that case, if the downside risks do not materialize and uncertainties become smaller, households and firms may come to expect higher economic growth.

If this happens, the current low interest rates will have a stronger impact on Japan's economy. Generally speaking, the prolongation of an accommodative financial environment in a situation where aggregate supply and demand in the economy remain more or less balanced tends to have an unfortunate effect on people's decision-making; they become unconsciously too optimistic in assessing risks, and firms and households as well as financial institutions may overextend themselves, resulting in a long-run misallocation of resources and significant swings in the economy. It seems that the recent economic slowdown as well as increased future uncertainty has reduced the risk that firms and households will overextend themselves. However, if the dense fog surrounding the outlook for the global economy gradually clears and as a result firms and households come to expect higher economic growth than previously, the current degree of monetary policy accommodation is likely to become overly strong relative to the level of economic activity.

C. Conduct of monetary policy in the near term

Next, I would like to talk about the Bank's conduct of monetary policy in the near term based on the outlook I have just described for economic activity and prices. Six months ago, the Bank indicated in its October 2007 Outlook Report that it would "adjust the level of interest rates gradually in accordance with improvements in the economic and price situation." In the April 2008 Outlook Report, however, the Bank stated, "Given the current situation where the outlook for economic activity and prices is highly uncertain, it is not appropriate to predetermine the direction of future monetary policy."

Needless to say, the Bank should, as a central bank, keep in mind that real short-term interest rates are currently at around 0 percent, an extremely low level. Once the Bank thinks that Japan's economy is highly likely to follow a path of sustainable growth with price stability, it will be appropriate to adjust the level of interest rates.

At present, however, the situation of Japan's economy demands that most attention be focused on the downside risks. Since the outlook for an economy always entails uncertainty, monetary policy decisions should be made not only based on the most likely projection but also fully taking into account factors that are risks to it. The Bank considers that currently the risks are unbalanced, and in conducting monetary policy more attention needs to be paid to downside risks to the economy stemming from uncertainties regarding future developments in overseas economies and global financial markets as well as the effects of high energy and materials prices. The Bank will pay close attention to future developments in economic activity and prices and, in particular, to whether downside risks will decrease, thereby increasing the likelihood of the economy realizing sustainable growth with price stability, or whether the probability of such risks materializing will rise.

So far, I have described the Bank's thinking regarding the conduct of monetary policy in terms of interest rate policy. Now, let me remind you of an important fact: proper functioning of financial markets is a prerequisite for monetary policy to be effective. It is therefore vital to ensure the stability of Japanese financial markets when global financial markets remain volatile.

Fortunately, Japanese financial markets have so far been stable unlike their U.S. and European counterparts. Mainly this is because Japanese financial institutions have had only limited exposure to subprime-related products, but I believe that a considerable role was also played by the fact that the Bank, based on its past experience of financial crises, had already established a framework for flexibly providing liquidity. As you know, since last summer central banks in North America and Europe have introduced various tools for liquidity provision to address elevated pressures in short-term funding markets. For example, the Fed has extended the maximum maturity of its funds-supplying operations to one month, from two weeks. The Bank employs funds-supplying tools with a variety of maturities – some of which have a maximum maturity of one year – and this enables the Bank to provide funds with the appropriate maturity. In March this year, the Fed introduced a credit facility that allows securities companies to borrow funds. The Bank has included securities companies as counterparties since 2001, when it introduced a complementary lending facility. As for collateral, central banks in North America and Europe have recently expanded the range of eligible collateral they accept, while the Bank has long accepted a broad range of assets as eligible collateral. Moreover, the Bank has a "pooled collateral" system, which allows counterparties to change their collateral in a flexible manner when necessary.

Needless to say, excessive use of such supportive measures may hamper the proper functioning of financial markets, which should operate autonomously, and therefore it is important to maintain a good balance between offering supportive measures and leaving things to the autonomous functioning of the market. What we have learned from Japan's experience in 1997 and subsequent years, however, is that once strains occur in borrowing from the market, smooth borrowing and lending become difficult, and problems cannot be easily resolved. In order to maintain a financial environment in which monetary policy accommodation effects derived from the present low interest rates are fully realized, the Bank will continue to carefully monitor market developments and to ensure the stability of the money market. It will also carefully assess the future outlook for economic activity and prices, closely considering the likelihood of its projections as well as factors posing upside or downside risks, and will implement its policies in a flexible manner.

II. Basic thinking concerning the conduct of monetary policy

Having dealt with the economic and price situation and the Bank's conduct of monetary policy in the near term, I would now like to spend the rest of the time talking about some fundamental points that I think significant for the conduct of monetary policy.

A. The importance of maintaining price stability in the medium to long term

First of all, I would like to emphasize the importance of correctly understanding "price stability," one of the objectives of monetary policy. The Bank of Japan Act stipulates that the Bank's currency and monetary control shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy. I strongly support the spirit of this provision, and would like to clarify the important point that "price stability" in the provision means stability that can be sustained in the medium to long term. The public seems to understand, as common sense, that price stability is essential and it is important that it continue in the medium to long term. However, in reality, policy actions aimed at realizing this objective are not necessarily supported by many people all the time. For instance, many of you may remember the situation during the economic bubble in Japan – in fiscal 1987 and fiscal 1988, the year-on-year rate of increase in the CPI stayed in the 0-1 percent range and this, coupled with other factors, caused the public to strongly oppose a possible raising of interest rates, despite the overheating of the economy. I do not think that low interest rates were the only factor behind the economic bubble, nor do I think that it is appropriate to conduct monetary policy with the aim of controlling asset prices. Nevertheless, I consider that, in conducting monetary policy, it is important to monitor various factors influencing the economy, including developments in asset prices, to realize sustainable economic growth with price stability. Assessment of the economic situation with such a wide-ranging perspective may lead to raising of interest rates under certain circumstances, even when price indicators suggest that prices are stable. On the other hand, even when inflation is suggested by data, central banks may need to reduce interest rates in particular situations. A good example would be an increase in consumer prices resulting merely from a temporary rise in crude oil prices due to supply-side factors. Reducing policy interest rates to respond to an economic downturn caused by deterioration in the terms of trade may contribute to ensuring economic growth with continued price stability – although such a policy action should be taken only when energy-related price rises are not leading to broad-based inflation accompanied by higher inflation expectations, in other words, there are no second-round inflation effects.

The Bank reviews and releases, annually in principle, the "understanding of medium- to long-term price stability" – that is, the level of inflation that each member of the Policy Board understands as being consistent with price stability over the medium to long term. The latest review conducted at the end of April indicated that there was no major change from the previous review – that is, the "understanding" expressed in terms of the year-on-year rate of change in the CPI currently falls in a range approximately between 0 and 2 percent, with most Policy Board members' median figures at around 1 percent. The Bank conducts monetary policy taking account of the "understanding."

B. Forecasts for the economy and prices bearing uncertainty in mind

The second point I would like to emphasize is that we should be fully aware of the fact that forecasts of economic activity and prices involve considerable uncertainty.

Economic forecasters, including central banks, do their utmost to provide accurate projections of economic activity and prices, but projection errors are often sizable. In the case of projections of the economic growth rate one year ahead presented by central banks as well as private and government organizations, for example, the average historical error ranges exceed 1 percent. This shows the current limit of human ability to predict the future. Considerable uncertainty attends the economic outlook, and it is therefore necessary to keep in mind the possibility that the economy will not evolve as projected, making it a prerequisite in the conduct of monetary policy to perceive factors posing both upside and downside risks. Some experts warned of the risk of a bubble in the U.S. housing market and, furthermore, the possibility of excessive position-taking in credit markets, as these might result in severe economic shocks. It is indeed important to have such a vision regarding the economy. I would, however, hesitate to endorse the opinion that the Fed should have had, a few years ago, a baseline scenario that incorporated a possible bursting of the housing bubble and disruptions in financial markets, and that it should have conducted monetary policy based on the scenario. From the perspective of policymakers, a convincing approach would be one where the possibility of the bursting of a bubble is regarded as a risk factor for the conduct of monetary policy – rather than one where it is incorporated in the baseline scenario. This is the basic concept behind the Bank's approach, where it assesses the baseline scenario, or the most likely outlook – the assessment from the "first perspective" – while assessing various risk factors and the cost that would be incurred should risks materialize – the assessment from the "second perspective."

The latest Outlook Report provides, in the form of charts, the aggregated probability distributions compiled from the distributions attributed by individual Policy Board members to the likelihood of divergence upward or downward from their forecast, with the aim of providing more detailed and visual descriptions of the level of risks to the forecast. Each chart shows a bell-shaped distribution with the most likely projection forming the top of the curve. The charts are called Risk Balance Charts, since they indicate how the risks are distributed around the central view and how the distributions are skewed. The Bank released these Risk Balance Charts because it considered that risks that were not deemed most likely by the Bank should also be described in a way that the public could understand easily.

C. Complex interdependency between financial and economic developments

The third point I would like to mention is that there is a complex interdependency between financial and economic developments, and this should be fully taken into account in assessment of the economic and price situation. This relationship can be seen in Japan's post-bubble experience in the late 1980s, the U.S. IT bubble in the late 1990s, and the recent subprime mortgage problem. It is difficult to explain these cases by using models derived from standard economic theory. What happened in U.S. financial markets recently was a decline in market liquidity. When this occurs, although sellers of financial products in the market offer prices, no one is willing to buy at those prices, resulting in a drastic shrinkage of market transactions. As a result, market participants are unable to take or hedge risks, and this in turn negatively affects economic activity.

Unfortunately, there is no perfect explanation of why this complex phenomenon occurs. This makes it all the more important for central banks to continue their efforts to steadily gather and analyze a wide range of data, including information relating to both economic activity and financial conditions as well as information at both the macro- and micro-economic levels, and to update the analysis as new information comes in. I think, while the variety of knowledge and experience accumulated within central banks should be fully mobilized, it is important for them to remain humble, fully recognizing the limits of human knowledge.

D. Examining the financial environment

The fourth point I would like to make is that assessment of monetary policy effects requires examination of the overall financial environment, including not only the level of nominal short-term interest rates but also developments in various other interest rates, the state of financial markets' functioning, and the lending stance of financial institutions.

Central banks use a short-term interest rate, usually an overnight rate, as their policy interest rate. In Japan, the policy interest rate is the uncollateralized overnight call rate, and the target level is currently set at around 0.5 percent. However, it is not only short-term interest rates that influence the spending behavior of firms and households, but also ones with longer maturities – in other words, all the interest rates that form the yield curve. It is also important to assess the level of interest rates in real terms, taking into account expected inflation rates. Furthermore, it should be borne in mind that firms, when borrowing from banks or from the market by issuing bonds, have to pay higher interest rates than risk-free borrowers such as the government, with spreads added onto the benchmark rates in accordance with their creditworthiness. In some cases, financial institutions may refuse to lend even if a borrower is willing to pay a higher interest rate.

Given the facts I have described, when assessing the effects of monetary policy and making policy decisions, it is vital to examine thoroughly not only the appropriate level of the policy interest rate but also the overall financial environment, which is suggested by the shape of the yield curve, the relationship between the level of the policy interest rate and the potential economic growth rate as well as the expected inflation rate, various credit spreads that are added onto benchmark interest rates, and the lending stance of financial institutions.

Conclusion

I have explained the basic points that are important for the conduct of monetary policy. In closing, I would like to touch upon a few issues related to the organization and behavior of central banks.

The first issue relates to the basis for central banks' independence – in other words, why they alone are entitled to conduct monetary policy. I explained earlier that a central bank takes policy action to ensure sustainable price stability in the medium to long term. Such action, however, may not be popular in the short term. What then justifies such action by a central bank? My answer is that accurate research and analysis by a central bank form the basis for the policy decision. The economy is constantly undergoing change, even at this moment, in a situation where economic globalization and development in information and communications technology are in progress. This is why I respect central bank culture, which attaches importance to being humble and always learning. In addition, it is indispensable for a central bank to explain clearly the reasons for its policy decisions – that is to say, it should ensure transparency. After all, a central bank's independence is based on years of experience in making policy decisions based on its accurate analysis, and on transparency with regard to its policy decisions.

The second issue relates to the importance of banking operations carried out by central banks. I have spoken today mainly about monetary policy, but a central bank's various banking operations also make an essential contribution to the development of the economy. To cope with the disruptions in global financial markets since last summer, central banks have taken various measures to provide financial markets with ample liquidity, or even acted as an intermediary. Their banking functions have played a crucial role in ensuring that those monetary policy actions take effect smoothly. Despite the unstable functioning of the markets since the summer, payment and settlement systems have not undergone major disruption. When financial markets experience turmoil, foreign exchange transactions are generally prone to settlement risk because of the time difference, and this can jeopardize the markets further. However, such problems have not occurred, and this is partly due to efforts by central banks over many years to enhance the payment and settlement system for foreign exchange transactions. These efforts of major economies' central banks and private banks brought a new system into effect in 2002 that realized settlement on a payment-versus-payment basis of transactions involving a pair of different currencies – for example, the yen and the U.S. dollar or the euro and the dollar. If this system had not been introduced until some years later, turmoil in the markets would have been more extensive. Moreover, preparations for unexpected events are just as important as the banking operations, and central banks have been enhancing business continuity planning for emergencies including earthquakes, terrorist attacks, and system failures.

In recent years, monetary policy has been attracting greater attention, and this is indeed welcome. However, it is only one aspect of central banks, and I hope that banking operations performed by central banks as "the bank for banks," their other aspect, will gain more recognition. Through the conduct of the two policies – monetary policy and banking policy – I will dedicate my efforts to ensuring stability in both prices and the financial system.