

Masaaki Shirakawa: Japan's economy and the conduct of monetary policy

Statement by Mr Masaaki Shirakawa, 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 Representatives, Tokyo, 20 April 2010.

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Introduction

The Bank of Japan submitted to the Diet its *Semiannual Report on Currency and Monetary Control* for the second half of fiscal 2008 and the first half of fiscal 2009 in June and December 2009, respectively. I am pleased to have this opportunity to talk about the recent developments in Japan's economy and present an overall review of the Bank's conduct of monetary policy.

I. Developments in Japan's economy

Japan's economy has been picking up mainly due to improvement in overseas economic conditions and to various policy measures, although there is not yet sufficient momentum to support a self-sustaining recovery in domestic private demand. The trend of pick-up is becoming more evident. Exports and production have been increasing mainly against a backdrop of robust growth in emerging economies. According to the March *Tankan* (Short-Term Economic Survey of Enterprises in Japan) released at the beginning of April, business sentiment has been improving, with such improvement spreading to the nonmanufacturing industry and small firms, in addition to large manufacturing firms. Business fixed investment is leveling out, and private consumption, notably durable goods consumption, is picking up mainly due to policy measures, despite the continued severe employment and income situation.

As for the outlook, the Bank projects that the pace of improvement of the economy is likely to be moderate for the time being, and it judges that the risk of the economy deteriorating substantially again, the risk of the so-called "double dip", about which market participants had expressed concern, has diminished considerably. Thereafter, as improvements in the corporate sector originating from exports are expected to spill over to the household sector, the growth rate of the economy is likely gradually to rise.

Financial conditions, with some lingering severity, have shown increasing signs of easing. Firms' borrowing rates from banks have continued to decline due in part to the fact that financial institutions' lending stance has become active, in addition to monetary easing by the Bank. Issuing conditions for CP are more favorable than in the period prior to the Lehman shock. Issuing conditions for corporate bonds have also been favorable, and even those for low-rated corporate bonds have shown signs of improvement. Meanwhile, although many small firms still see their financial positions as weak, the overall financial positions of firms, including small ones, have continued to show signs of easing.

The CPI (excluding fresh food) is declining on a year-on-year basis due to the substantial slack in the economy as a whole, but the decline leveled out in August 2009 and the moderating trend of decline has continued. The outlook for the trend change in prices is determined by the aggregate supply and demand balance and the medium- to long-term inflation expectations. It should be noted that, statistically, the year-on-year rate of change in the CPI will decline for a year due to the introduction of subsidies for high school tuition and other policy measures in fiscal 2010, but in assessing the trend change in prices, it is necessary to exclude such one-off factors. In terms of the trend change in prices, with medium- to long-term inflation expectations likely to be stable, the year-on-year rate of

decline in the CPI (excluding fresh food) is expected to continue to moderate as the aggregate supply and demand balance improves gradually.

While I have thus far explained the baseline scenario for economic activity and prices, the Bank is also fully aware of the risks concerning such scenario. Upside risks to the scenario are developments in emerging and commodity-exporting economies. The robust growth of emerging and commodity-exporting economies has driven the pick-up of Japan's economy. If the growth in those economies further accelerates, it will pose an upside risk to economic activity in Japan. Meanwhile, downside risks, although somewhat diminished, include the possible consequences of balance-sheet adjustments in the United States and Europe as well as potential changes in firms' medium- to long-term growth expectations. Moreover, attention should continue to be paid to various recent international financial developments and their effects. With regard to prices, there is a risk that inflation will rise more than expected in the event of a rise in commodity prices due to higher growth rates in emerging and commodity-exporting economies. On the other hand, there is also a risk that the rate of inflation might decline due, for example, to a decline in medium- to long-term inflation expectations.

II. Conduct of monetary policy

The Bank recognizes that Japan's economy is faced with a critical challenge of overcoming deflation and returning to a sustainable growth path with price stability. Therefore, the Bank has been implementing various measures, taking into account the two factors that determine the trend change in prices.

As a measure to prompt an improvement in the aggregate supply and demand balance, in terms of interest rates, the Bank has kept the policy rate at the effectively zero level. To encourage a further decline in longer-term interest rates in the money market, the Bank introduced in December 2009 a new funds-supplying operation, through which funds with a maturity of three months are provided at an extremely low interest rate of 0.1 percent, and the total amount of loans to be provided through this operation was set at approximately 10 trillion yen. The total amount of loans was increased to 20 trillion yen in March 2010. In terms of funds provision, the Bank has been providing ample funds through various funds-supplying operations, including the new operation. Furthermore, the Bank has made its stance clear that it will consistently maintain the extremely accommodative financial environment.

As for inflation expectations, the other determinant of prices, the Bank has, to prevent people's expectations for prices from declining, clearly showed its stance, in the form of the "understanding of medium- to long-term price stability", that it is critical to achieve a positive year-on-year rate of changes in the CPI.

To overcome deflation and achieve a sustainable economic growth with price stability, the Bank will continue to consistently make contributions as central bank.