Takahide Kiuchi: Recent developments in economic activity and prices and future monetary policy

Speech by Mr Takahide Kiuchi, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Kanagawa, 28 February 2013.

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I. Current situation of overseas economies and their prospects for a moderate recovery

A. Easing of tension in global financial markets

I would like to start my speech with a look at overseas economies. Developments in global financial markets continue to require vigilance, especially in terms of the European debt problem and the fiscal problem in the United States. Nevertheless, tension in the financial markets has eased significantly since around autumn 2012, as evidenced by the repurchasing of risk assets such as currencies of emerging economies and stocks and the selling of advanced economies' government bonds and the yen, which had been purchased as a safe currency. Three things seem to be at work in the background to these developments. First, in Europe and the United States, a decline has occurred in tail risks – risks with a low probability of materialization but a devastating impact if they materialize. This reflects the fact that in Europe the possibility of disintegration of the euro has fallen significantly, supported by (1) the approval of new disbursement of financial assistance to Greece, (2) some progress achieved in fiscal consolidation and economic structural reforms by peripheral European countries such as Portugal and Spain, and (3) the introduction of safety valves such as the European Stability Mechanism (ESM). In addition, at the beginning of 2013 the United States avoided the "fiscal cliff," a state in which the expiration of large-scale tax cuts and substantial fiscal spending cuts threatened to occur simultaneously. Second, investors' confidence has returned due to expectations regarding policy measures, as central banks in advanced economies such as the United States and Europe as well as Japan have conducted aggressive monetary easing. Third, expectations have grown that the global economy will pick up, as the U.S. and Chinese economies have firmed since autumn 2012.

B. Gradual pick-up in overseas economies from a deceleration phase

While overseas economies remain in a deceleration phase as a whole, signs of a pick-up have been observed. The U.S. economy has been on a moderate recovery trend. Business sentiment that had been cautious due to concerns over the fiscal cliff has improved somewhat, and business fixed investment has shown signs of a pick-up. In the household sector, firmness in housing investment and car purchases has become pronounced partly due to the effects of the decline in long-term interest rates. As for the outlook, the recovery trend in the U.S. economy is likely to gradually strengthen in the latter half of 2013, as the effects of expiration of tax cuts wane and uncertainties diminish in regard to fiscal spending cuts and the debt ceiling problem.

Economic activity in the euro area remains weak. From the latter half of 2013, however, economic activity is likely to gradually recover particularly in core countries such as Germany and France. This is because (1) disturbances in financial markets have been diminishing; (2) the degree of fiscal austerity, while continuing, has eased somewhat; and (3) the competitiveness of peripheral countries' exports has begun to recover with the progress in structural reforms, including reductions in labor costs.

The Chinese economy has been generally picking up since autumn 2012, as the government's expansionary fiscal measures centered primarily on infrastructure investment and monetary easing measures have been producing positive effects. The real GDP growth rate in the January-March quarter of 2013 is expected to recover to the 8.0–9.0 percent level for the first time in a year.

In these circumstances, looking at the outlook for the global economy as a whole, the real GDP growth rate is expected to accelerate moderately from 3.2 percent in 2012 to 3.5 percent in 2013 and 4.1 percent in 2014, according to the latest World Economic Outlook released by the International Monetary Fund (IMF) in January 2013. If the global economy – led by emerging economies – registers growth rates as projected, the rates will be above the historical long-term average.

II. Current situation of Japan's economy and its prospects, with the key factor of a pick-up in overseas economies

A. Leveling out of Japan's economy

Japan's economy remained relatively weak during the latter half of 2012, as exports and production decreased significantly due mainly to the deceleration in overseas economies, which in turn adversely affected domestic demand such as business fixed investment in the manufacturing industry. However, recent developments show that the pace of decrease in exports has been moderating and production appears to have stopped decreasing. Based on these developments, at the Monetary Policy Meeting (MPM) held on February 13 and 14, 2013, the Bank of Japan revised upward its basic assessment of the domestic economy, from an assessment that the economy remained relatively weak to an assessment that it appeared to have stopped weakening.

The leveling out of production is mainly attributable to three factors. First, the effects of the ending of subsidies for purchasing energy-efficient cars, which temporarily exerted strong downward pressure on car production, have fallen off. Second, the effects of the recent developments in the relations between Japan and China, which dealt a serious blow particularly to exports of cars and related items, have eased somewhat. And third, the pace of decrease in exports has been moderating as overseas economies such as the United States and China have shown some signs of picking up. Nevertheless, while exports are showing some signs of leveling out, it is necessary to closely monitor whether a clear increase will occur in exports, which are expected to become the driving force of a full-fledged economic recovery. Consequently, uncertainty remains over how Japan's economy will achieve a full-fledged recovery.

B. Effects of fiscal policy measures, the depreciation of the yen, and the rise in stock prices

Japan's growth rate for 2013 is expected to rise relatively steadily, in line with the accumulation of temporary boosting effects of various policy measures. First, the implementation of the supplementary budget for fiscal 2012 of about 20 trillion yen is expected to have an effect, particularly in public investment, from the April-June quarter of 2013 onward. Second, the recent developments in foreign exchange rates and stock prices – supported in part by expectations for the new administration's economic and fiscal policies as well as for the Bank's enhancement of monetary easing – are expected to gradually have positive effects mainly in exports and private consumption. Third, a front-loaded increase in demand prior to the hike in the consumption tax scheduled in April 2014 is likely to take place particularly in demand for housing and durable consumer goods.

According to the median of the forecasts of the majority of the Bank's Policy Board members in the interim assessment of the October 2012 *Outlook for Economic Activity and Prices*, released in January 2013, the real GDP growth rate is expected to be 1.0 percent for fiscal 2012, accelerate to 2.3 percent for fiscal 2013, and decline to 0.8 percent for fiscal 2014 even after accounting for the effects of the consumption tax hike. The year-on-year rate of change in the consumer price index (CPI) for all items less fresh food is expected to rise gradually reflecting an improvement in the output gap as a result of the economic growth rate continuing to exceed the potential growth rate. As for the median of the forecasts, the year-on-year rate of change in the CPI is projected to be minus 0.2 percent for fiscal 2012, 0.4 percent for fiscal 2013, and 0.9 percent for fiscal 2014 excluding the direct effects of the consumption tax hike. Meanwhile, with regard to risk factors, attention should be paid to the prospects for the European debt problem, the momentum toward recovery for the U.S. economy, the possibility of emerging and commodity-exporting economies making a smooth transition to a sustainable growth path, and the effects of the recent developments in the relations between Japan and China. With these factors taken into consideration, a high degree of uncertainty remains concerning Japan's economy.

III. Downside risks to the economic outlook

A. Weak recovery of overseas economies

With respect to the aforementioned baseline scenario of the outlook for economic activity and prices in Japan, I consider the downside risks to be rather large.

The greatest concern arises from the possibility of the deceleration in overseas economies. Although overseas economies are likely to gradually emerge from their current deceleration phase, the sustainability of their recovery will likely remain unpredictable. In the United States, housing investment and private consumption are expected to be the driving force of the pick-up in the economy in the short run; if the recent uptrend in long-term interest rates strengthens suddenly, however, this could adversely affect funding for housing investment and car purchases. Attention should also be paid to the risk that the persisting uncertainty over fiscal policy could exert downward pressure on the U.S. economy with an influence on public sentiment.

With regard to the euro area, it is necessary to remain continually vigilant against the risk that financial markets could suffer renewed disturbance if political and social instability hinders fiscal consolidation and economic structural reforms and if slow progress in coordinating national interests hampers Europe's ongoing integration such as the formation of fiscal and banking union. In addition, since banks' lending attitudes have not shown signs of easing, there is a risk that funding constraints could prevent the economy from emerging from the deceleration phase for a long time.

As for China, the government's policy stance is the focus of attention. Because aggressive fiscal measures adopted after the Lehman shock left many issues unresolved – such as excessive capital stock and an overheating in the real estate market – China's previous administration had remained cautious about public spending despite a decelerating economy. The current administration also appears to be maintaining a cautious stance. In addition, the Chinese government remains vigilant against (1) a rise in the inflation rate, (2) an upturn in major cities' housing prices, which the previous administration had sought to contain, and (3) a rapid expansion in shadow banking such as trust business, where personal assets are flowing in to gain high returns. The possibility should therefore not be ruled out that the government will reverse its accommodative stance on fiscal policy. In terms of monetary policy, the People's Bank of China has indicated its intention of placing top priority on controlling inflation. Moreover, in response to the expansion in bank lending in January 2013, the authorities have reportedly instructed large banks to constrain lending. The authorities have stated their intention of strengthening risk management associated with shadow banking, in which case there is a risk that infrastructure investment and real estate investment will be significantly suppressed.

B. Continuation of a large negative output gap in the major economies

Aside from the short-term downside risks I have mentioned, there is concern over the medium to long term: it could take time before the U.S. and European economies, as well as the Chinese economy, overcome the aftereffects of the credit bubble. Similar to what occurred in Japan, firms will likely continue their cautious stance on employment and households' medium- to long-term income expectations are likely to weaken in view of the persistently high unemployment rate, causing the economies to lag behind in achieving a self-sustaining recovery with an expansion of employment and income. What I wish to highlight here is that since the Lehman shock, the output gap – which indicates the aggregate demand and supply balance – has been largely negative across the advanced economies. According to the Organisation for Economic Co-operation and Development (OECD), the output gap in the advanced economies, after having reached minus 4.0 percent of GDP in 2009, is expected to exceed minus 3.0 percent in 2013, at minus 3.3 percent. In the OECD's projections for the output gap as of November 2012, the output gap of Japan is minus 2.1 percent for 2013, but that of the United States and of the euro area is substantially more negative.

The large negative output gap in the advanced economies indicates a prolonged excess in production capacity and labor in the aftermath of the credit bubble, appearing in the form of balance-sheet adjustments. This type of situation causes firms to post lower profits and further restrain investment, and causes households to lower their income expectations and restrain consumption, exerting downward pressure on the already-declining inflation rate. With this situation spreading widely in the major economies, which are Japan's main export destinations, considerable uncertainty will inevitably remain over Japan's export environment in the long run.

C. Expansion of trade deficit and financial market stability

With regard to the downside risks to Japan's economy, due attention should be paid to the continued trend in the expansion of trade deficit and its effects on financial markets. As I mentioned, Japan's economic growth rate is expected to rise relatively smoothly for the time being, but the recovery of overseas economies could lack momentum. In addition, imports of raw materials are expected to remain at a high level. This situation could cause Japan's trade deficit to expand. An expansion of the trade deficit causes the yen to depreciate mainly through changes in the supply-demand balance in foreign exchange markets. This could then destabilize financial markets, because not only a buoyant economy and a rise in import prices but also a reduction in surplus funds in the domestic markets cause long-term interest rates to rise. Attention should therefore be paid to the effects of the expansion of trade deficit on financial markets as well as economic activity.

Furthermore, long-term interest rates could rise if credibility of the conduct of fiscal policy is undermined. The rise in long-term interest rates could significantly affect Japan's economy, and depending on the degree of the rise, could also affect the economy by greatly aggravating instability in the banking system. Long-term interest rates in Japan have been stable so far, and this may be regarded as evidence that the credibility of fiscal policy is being maintained. However, given that unexpected events may trigger sudden and nonlinear changes in market sentiment, as experienced with the European debt problem, it is necessary to continue careful monitoring to identify the changes as risk factors.

IV. Developments in prices and wages in Japan and their characteristics

Before I move onto my next topic of monetary policy conduct, I would like to discuss developments in prices and wages in Japan, which are closely linked to my topic, and give my personal view on the background to the prolonged deflation.

A. Historical developments in Japan's inflation rate and a comparison with other major economies

Since the 1980s, Japan's inflation rate has remained at a consistently low level, unlike the case of other major economies. According to the OECD, during the decade from 1985 to

1995, the year-on-year rate of change in the CPI in the G-7 countries was 3.3 percent on average, while in Japan it was 1.4 percent. For the 15 years thereafter, from 1996 to 2011, the year-on-year rate of change in the CPI in the G-7 countries was 1.9 percent on average, while in Japan it was minus 0.1 percent. The difference between the averages of Japan's inflation rate and those of the G-7 countries remained mostly unchanged: approximately 1.9 percent for the first ten years from 1985 and around 2.0 percent for the 15 years thereafter, when Japan's economy fell into deflation. This indicates that, during the 25 years as a whole, Japan and the other major economies generally experienced a long downtrend in their inflation rates.

I see in this the possibility that Japan's deflation might have been brought about by the downtrend in global inflation.

In particular, a large negative output gap – a state of excessive supply – continues to be seen in the major economies since the Lehman shock, on the back of balance-sheet adjustments in the aftermath of the credit bubble. This has created an environment where the inflation rate is subject to downward pressure, and such developments overseas could also be considered to have exerted downward pressure on price developments in Japan.

B. Major factor behind the difference between inflation rates in Japan and the United States: the service sector

I would also like to compare and examine price developments in Japan and abroad. For example, if we compare price developments in Japan and the United States, in Japan the year-on-year rate of change in the CPI was minus 0.2 percent on average between 1997 and 2011, while in the United States it was 2.4 percent, resulting in a gap of 2.6 percentage points. The major factor behind this was a difference in the contribution of prices of services less rent, which accounted for about one-third of the 2.6 percentage point gap, or 0.9 percentage point. When rent was included, services prices accounted for almost two-thirds of the gap, or about 1.7 percentage points. In my view, the fact that services prices are typically susceptible to developments in wages may indicate the reason why Japan's price structure is prone to deflation and suggest how deflation can be overcome.

C. Relationship between the potential growth rate, wages, and prices

As seen earlier, according to the OECD, since 2009 – when the negative output gap expanded worldwide due to the effects of the Lehman shock – the negative output gap in Japan has not been particularly large compared with other major economies, and this suggests that the level of the output gap does not solely determine the level of the inflation rate. In considering the cause of deflation in Japan, attention should therefore be paid to the supply-side factors, such as the rate of increase in labor productivity and the economy's potential growth rate.

In Japan, there is a relatively strong correlation between the potential growth rate per capita and medium- to long-term inflation expectations. This relationship is considered to reflect the customary practice prevailing between employers and employees: when medium- to long-term growth expectations declined after the bursting of the economic bubble, Japanese firms tended to adjust wages rather than employment, and workers tended to accept such adjustments. Although Japan has experienced prolonged deflation that is unprecedented among major economies, its unemployment rate has remained very low relative to other economies and the employment situation has shown outstanding stability. In the United States, on the other hand, employment has fallen but declines in wages and prices have remained quite limited amid economic deterioration. These contrasts show how means of adjustment in the labor market differ between Japan and the United States.

With these points taken into account, an end to deflation and a further rise in Japan's inflation rate require efforts to strengthen the growth potential to raise the economy's potential growth rate and subsequently boost growth expectations. Such improvements are expected to result in an increase in services prices through a rise in the rate of wage increase. However, if wages increase unaccompanied by a strengthening in the growth potential and a rise in productivity, this will depress corporate profits, which in turn could restrain business fixed investment and hamper steady economic growth. The possibility of a resultant deterioration in the employment and income situation is a matter of concern. On the other hand, if the inflation rate increases while the growth potential does not strengthen and wage inflation remains unchanged, the general standard of living will fall in real terms. In sum, the economic condition to be sought is a balanced increase in wages and prices on the basis of a strengthened growth potential.

V. Current and future conduct of monetary policy

A. Decisions made at the MPM held on January 21 and 22, 2013

At the MPM held on January 21 and 22, 2013, the Bank decided to take additional steps to provide monetary accommodation decisively by introducing two measures: the "price stability target" of 2 percent in terms of the year-on-year rate of change in the CPI; and the "open-ended asset purchasing method" for the Asset Purchase Program (hereafter the Program). In addition to these two measures, another important decision was the strengthening of policy coordination between the government and the Bank. The Bank, together with the government, decided and released "Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth."

The Bank had previously adopted a "price stability goal in the medium to long term," judged to be in a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI, and set a goal at 1 percent for the time being. As I will explain in detail later, the Bank replaced this goal with the "price stability target" of 2 percent for the following reasons. First, there is an increasing awareness among the general public that even if the Bank were to use the term "price stability target" it would not conduct monetary policy in an automatic manner in pursuit of a certain inflation rate. And second, as progress is achieved through efforts by a wide range of entities – such as those by the government to strengthen the competitiveness and growth potential of Japan's economy – an increase is likely to occur in the inflation rate at which firms and households perceive price stability – the basis for their economic activity. There is uncertainty with regard to how the strengthening of the growth potential of Japan's economy will proceed, but the Bank expects the setting of this very ambitious target to have the secondary effect of encouraging efforts by a range of entities. In this regard, the "price stability target" of 2 percent could serve in a sense as a kind of "slogan" for the general public in the revitalization of Japan's economy.

Moreover, the Bank has introduced the "open-ended asset purchasing method" without setting any termination date, to clearly show its strong determination to achieve the "price stability target" of 2 percent, which it considers will result in greater policy effects. Under the current purchasing method – which makes a commitment in terms of the future level of the total size of the Program – the total size of the Program will be increased to 101 trillion yen by end-2013 from 65 trillion yen at end-2012, as had been planned earlier. From January 2014 and for some time, the Bank will purchase about 13 trillion yen in financial assets, including about 2 trillion yen of JGBs, every month without setting any termination date.

B. The Bank's price stability target and its importance

Next, I would like to discuss in more detail the inflation targeting system, looking at examples of overseas systems. Article 2 of the Bank of Japan Act stipulates that "currency and monetary control by the Bank of Japan shall be aimed at achieving price stability, thereby contributing to the sound development of the national economy." This tells us that achieving price stability is the precondition for the sound development of the national economy and that the sound development of the national economy – which deeply impacts public welfare – is the ultimate target of the monetary policy conduct. Based on this thinking, in policy conduct aimed at achieving the price stability target, it is most important to aim at contributing to the stability and development of the economy in the medium to long term, and to carefully conduct policy while monitoring the soundness of the financial system. At the same time, it must be noted that policy conduct aimed at guiding the inflation rate to the target in an automatic manner in fact entails the risk of hampering medium- to long-term economic stability.

C. Flexible inflation targeting system

The introduction of an inflation target by the Reserve Bank of New Zealand in 1988 was a first among the central banks of the major economies, followed by the central banks of Canada and the United Kingdom. In New Zealand, the central bank aimed at the target rigidly in the beginning, but later it was recognized that this rigidity was destabilizing the economy. For this reason, the introduction of an inflation target was deferred by the central banks of Japan, the United States, and other major economies in Europe. Subsequently, however, central banks adopting an inflation target have made adjustments to boost flexibility. Many of the central banks have not specified the timing for achieving the target. Even the Bank of Canada – which specified the term for achieving the target as "typically within a horizon of six to eight quarters" – allows adjustments in the length of the term depending on developments in economic activity and prices to ensure the target's flexibility. As a result, central banks in major economies are at present conducting policy aimed at achieving sustainable growth with price stability while assessing the current developments and outlook for economic activity and prices as well as examining various risks, including those stemming from the accumulation of financial imbalances. This policy framework is often referred to as the flexible inflation targeting system. The price stability target adopted by the Bank of Japan is based on the same thinking. The Bank has clarified that it will aim to achieve this price stability target of 2 percent "at the earliest possible time." The intention behind this clarification is that, as discussed earlier, in achieving an inflation target it is important – from the viewpoint of ensuring medium- to long-term stability of the economy – to secure flexibility in the policy conduct while carefully ascertaining risks arising from, for example, the accumulation of financial imbalances. The Bank will aim to achieve the target "at the earliest possible time" on this basis.

In other major economies, central banks have introduced inflation targets with the aim of containing rising inflation and reinforcing their independence from the government by ensuring the transparency of their policy conduct. The Bank of Japan, on the other hand, has introduced the price stability target in an attempt to overcome deflation. This point differs from the inflation targets of other central banks, and therefore the Bank's action may be regarded as an unprecedented endeavor.

D. Votes at the MPMs held in January and February

So far, I have explained the decisions made at the MPM held on January 21 and 22, 2013. At the meeting, I voted against the introduction of the price stability target of 2 percent in terms of the year-on-year rate of change in the CPI. The main reasons for my vote have already been outlined in the minutes of the MPM, which were released on February 19. Although my remarks here will thus repeat them, I would like to briefly review the three reasons outlined in the minutes. First, while the inflation rate consistent with sustainable price stability pursued by the Bank is considered to be largely affected by the general public's current perception of price developments, 2 percent in terms of the year-on-year rate of change in the CPI had rarely been achieved in the past two decades, and based on the general public's current perception of price developments that is built on such past experience, the 2 percent inflation rate is considerably higher than the inflation rate that is considered at this point to be consistent with sustainable price stability. Second, this suggested that, even if the central bank were to set 2 percent inflation as a target, this alone is highly unlikely to substantially influence inflation expectations. Third, efforts by a wide range of entities toward strengthening the growth potential of Japan's economy are essential in order to achieve the

2 percent target, but if the 2 percent target were set before such efforts made progress and the effects of these efforts were confirmed, this could impair the credibility of monetary policy due to considerable uncertainty regarding achievement of the target. For these reasons, I judged that the Bank's commitment to do its utmost to achieve the target of 1 percent in terms of the year-on-year rate of change in the CPI for the time being would further enhance the policy effects and be more appropriate in the current situation.

Subsequently, at the MPM held on February 13 and 14, I voted for the public statement that included the following sentence: "the Bank has set the price stability target at 2 percent in terms of the year-on-year rate of change in the CPI." I still hold the view that it is not an easy task to achieve the price stability target of 2 percent. Neither is there a significant change in the general public's perception of price developments at present. However, in line with the recognition that a range of entities, including the government and the private sector, will fulfill their respective roles to overcome deflation, I considered that financial market developments after the introduction of the price stability target of 2 percent appeared to reflect expectations for the Bank's monetary policy and the government's various policy measures, and that it was important to further increase credibility regarding the Bank's decision on the price stability target of 2 percent from the viewpoint of overcoming deflation. While monitoring the effects of monetary policy and their spread through the economy, the Bank will conduct policy aimed at achieving this target in a responsible manner, by carefully communicating its policy intentions and considering a decisive action for additional monetary easing as necessary.

E. The Bank's policy stance on achieving the 2 percent price stability target

In my opinion, the Bank's decision to introduce the open-ended asset purchasing method with the aim of achieving the 2 percent price stability target indicates that asset purchases through market operations will continue to form the core of the Bank's policy to enhance monetary easing. Specifically, this decision is based on the idea that the Bank will give greater consideration to producing policy effects by affecting market prices, which is what the comprehensive monetary easing policy has been aiming for. This means encouraging a decline in longer-term interest rates and a reduction in risk premiums and thereby ensuring financial conditions that allow firms and households to raise funds at low cost.

There seems to be a range of views in financial markets currently on the feasibility of the 2 percent price stability target. If any doubt arose in the markets over the Bank's stance on achieving the target, this could reduce the policy effects. Therefore, with a view to avoiding such a situation and continuing to clearly show the Bank's strong determination to achieve the target, it is important to steadily conduct asset purchases under the Program in a sustainable manner and thereby produce the intended policy effects. In this regard, I will discuss three points: steadily increasing the amount outstanding of the Program; strengthening coordination with the government and maintaining fiscal consolidation; and communication to the public to gain understanding of the Bank's policy intention.

F. Issues regarding the operation of the asset purchase program

First, let me mention an issue concerning the payment of interest under the complementary deposit facility, or the payment of interest on excess reserve balances of financial institutions' current accounts at the Bank. This issue needs to take into account the fact that undersubscription – that is, aggregate bids falling short of the Bank's offers – has been occurring frequently in the fixed-rate funds-supplying operation against pooled collateral since the turn of the year. Generally speaking, as the degree of monetary easing is enhanced, financial institutions' demand for liquidity will be met sufficiently, thereby reducing their need for funds provided by the Bank; consequently market participants will have a reduced incentive to submit bids for the Bank's market operations. Moreover, the bidding activity for market operations is affected by not only the supply and demand conditions of market participants' funds but also various events and speculation in the markets. Therefore, with regard to financial institutions' current accounts held at the Bank, the balances of which change along with the Bank's asset purchases, careful deliberation is necessary in discussing the lowering or the abolishment of the payment of interest on excess reserve balances of the current accounts. Since such a move would affect financial institutions' incentive to hold excess reserves at the Bank, the costs and benefits should be assessed while taking into account the sustainability of asset purchases under the Program.

Second, it should be noted that the remaining maturity of JGBs to be purchased under the Program is currently one to three years. This takes into account the fact that the average financing term used by Japanese firms is around three years. On this point, some market participants, for example, have called for extending the remaining maturity of the JGBs to be purchased under the Program. Some have noted the importance of enhancing policy effects by encouraging a decline in longer-term interest rates, and others have mentioned the need to conduct asset purchases under the Program smoothly and to ensure the sustainability of the purchases.

And third, the Bank purchases risk assets – namely, CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs) – for the purpose of encouraging a decline in risk premiums in the markets, while paying due attention to the potential cost of impairing the Bank's balance sheet. On this point, some market participants have stated that the Bank should increase the amount of risk assets it purchases.

In this regard, in deliberating on the possibility of either extending the remaining maturity of JGBs to be purchased under the Program or increasing the amount of risk assets to be purchased, it is essential for the Bank to carefully assess costs and benefits in light of its policy objective of achieving the 2 percent price stability target, while giving due consideration to the two points mentioned earlier: ensuring the sustainability of asset purchases under the Program and producing the intended policy effects.

G. Importance of strengthening coordination with the government and maintaining fiscal consolidation

The joint statement indicates that the Bank sets the price stability target at 2 percent in terms of the year-on-year rate of change in the CPI, and under the target it will pursue monetary easing and aim to achieve this target at the earliest possible time. At the same time, the government will formulate measures for strengthening the competitiveness and growth potential of Japan's economy, and promote them strongly, as well as steadily promote measures aimed at establishing a sustainable fiscal structure.

In order for the Bank to pursue powerful monetary easing with the aim of achieving the 2 percent price stability target, it is important for the credibility of fiscal management to be firmly ensured in the financial markets. In this regard, it is worth noting the obvious: the policy coordination mentioned in the joint statement does not indicate "monetization," that is, the central bank's financing of the government's fiscal deficit. The firm guarantee by law in many countries of a central bank's independence is the result of bitter experience. Specifically, the underwriting of government securities by central banks during wartime led to a substantial expansion of government debt, which became a burden for future generations. This underwriting also accelerated inflation and destabilized financial markets and the financial system, which seriously degraded people's living conditions.

Japan experienced sharp inflation immediately after the end of World War II, and in response the yen was revalued and a freeze on bank deposits was imposed. While the number of people who actually experienced these events is gradually declining, one of the vital roles of a central bank is to continue to provide a warning about the dangers of monetization based on the lessons of history.

In addition to preventing monetization at all costs, it is essential to avoid even the emergence of mere doubt in financial markets as to whether the Bank's action could be considered monetization. If such doubt should emerge, the credibility of fiscal policies would be undermined to a substantial degree and a fiscal crisis could occur, which in turn would inflict considerable damage on economic activity, together with a crisis in the financial system. It should be recognized that, in such a case, the quality of people's lives would be significantly impaired.

In addition to the joint statement in which the government clarified its stance of emphasizing fiscal discipline, the Cabinet decided the fiscal consolidation target, which aims at halving the primary balance deficit relative to GDP by fiscal 2015 from the fiscal 2010 level and achieving a surplus by fiscal 2020. It appears that these moves will contribute to containing the risk that concern over monetization will emerge in financial markets. If the government's determination regarding fiscal consolidation spreads further in the markets – through its communication about the consistency between the supplementary budget for fiscal 2012 and the medium-term fiscal consolidation policy as well as the path to achieving fiscal consolidation – this will give the Bank more room to proceed with purchasing government securities without causing concern over monetization. This would also help achieve the 2 percent price stability target.

H. Importance of communication to the public to gain understanding of the Bank's policy intention

With a view to strengthening the policy coordination between the Bank and the government, it is important to deepen the public's understanding of the Bank's thinking on the conduct of monetary policy and its specific actions. The Bank considers it essential to make its utmost efforts to this end. To my understanding, the issues that need to be explained thoroughly to deepen the public's understanding are as follows. First, as the principle of the conduct of monetary policy, it is important that the policy should aim at achieving price stability, thereby contributing to the sound development of the national economy. Second, regarding the effects of monetary policy on price developments, I continue to attach importance to the transmission mechanism in which monetary policy influences demand, thereby encouraging the improvement in the output gap; in this regard, the transmission mechanism in which monetary policy underpins inflation expectations is also noteworthy. And third, I consider that the medium- to long-term trend in inflation rates is largely determined by supply-side factors, such as the growth rate of productivity and the potential growth rate of the economy, or in other words, by the growth potential of the economy.

I. Function of Policy Board members in making monetary policy decisions

In the remainder of my remarks, I will briefly touch on the central bank committee system in which monetary policy decisions are made as a result of deliberations among committee members, rather than by any one individual. The Bank of Japan Act stipulates that the Policy Board shall be established, composed of nine members – the Governor, two Deputy Governors, and six Members of the Policy Board. It also stipulates that matters concerning monetary policy shall be decided by the Policy Board. This type of committee system is currently adopted by not only the Bank of Japan but also other major central banks. In his book *The Quiet Revolution: Central Banking Goes Modern*, Alan S. Blinder, a former vice chairman of the Board of Governors of the Federal Reserve System, positively assessed the advantage of group decision making by policy committee on the basis of certain assumptions. He pointed to two developments behind the spread of the committee system: the worldwide trend of increased central bank independence from the government; and growing recognition of the system's success in the United States and Germany, where it had been introduced as a pioneering effort. He also noted that decision making by members of a committee could help avoid certain risks associated with decision making by a single individual and thereby generate better outcomes.

In the vote taking, each member of the Bank of Japan's Policy Board is given an equal vote and makes a judgment independently. The split vote that occurred at the January 2013 MPM demonstrates that each member's autonomy is respected. This is also reflected in the provisions of the Bank of Japan Act that the members of the Policy Board shall be appointed by the Cabinet, subject to the consent of the House of Representatives and the House of Councillors, and shall not be dismissed against their will during their terms of office of five years, except in special cases such as becoming incapable of carrying out their duties due to mental or physical disorder.

At the same time, we the Policy Board members conduct our daily duties by fully recognizing the responsibility that we – who are not chosen by election – are granted considerable authority to make monetary policy decisions, which significantly affect people's lives. Therefore, in order to maintain and enhance the public's trust, I believe that it is vital to further enhance the transparency of the conduct of monetary policy – that is, communication to the Diet and the public by thoroughly explaining the Bank's thinking on the conduct of monetary policy. We are also listening with all due respect to the government's and public's opinions on monetary policy conduct and working to incorporate them into policymaking, and I regard today's meeting as one such opportunity for this.