Mr. Matsushita considers the role of monetary policy in Japan Translated excerpts of a speech given by the Governor of the Bank of Japan, Mr. Yasuo Matsushita, at the Research Institute of Japan in Tokyo on 06/11/96.

I. Introduction

I am greatly honored to have been invited by the Research Institute of Japan to address this distinguished audience.

Today, I would first like to discuss the Bank of Japan's views on recent economic developments in Japan and the thinking behind the Bank's current monetary policy. Then, I would like to review some of the basic issues related to monetary policy management, such as the significance of price stability, which is the objective of monetary policy, and the points for consideration in achieving it.

There has been much debate since the beginning of this year about Japan's central bank system, and the Central Bank Study Group, an advisory panel to the Prime Minister, is planning to publish a report in the near future. I myself have, on several occasions, addressed the basic issues involved, such as the status of the central bank within the framework of a democratic society, and the role of the central bank in maintaining financial system stability.[1] As my previous speeches focused on the institutional framework of central banking, there has not been an opportunity to discuss the Bank of Japan's views on the central bank's policy management.

I have thus selected monetary policy as the theme of today's speech. However, there is another reason. Over the past decade, it seems that a new thinking has been developing among the industrialized countries regarding monetary and fiscal policy management, or more broadly, the economic policy management of a country. This has prompted heated discussions in various countries in recent years on monetary policy and central banking, and this new thinking will be of great significance in contemplating the future framework of the Japanese economy. I would therefore like to examine the role of monetary policy, bearing in mind this new thinking on economic policy management.

II. Domestic Economic Conditions and Current Monetary Policy

A. Domestic Economic Conditions

I would like to begin by reviewing domestic economic conditions. In spring 1995, the recovery of the Japanese economy came to a pause and, at one time, there were even concerns about a deflationary spiral. In view of these economic developments, substantial monetary easing and large-scale fiscal policy measures were implemented. Since the beginning of this year, the economy has once again been on a recovery path, owing to the permeation of policy effects and the depreciation of the yen. The Bank currently judges that a moderate economic recovery continues, but there are concerns as to why the economy has not shown a recovery that is any stronger than "moderate" for nearly a year.

This slow recovery can be explained by the tug-of-war between the forces encouraging recovery and the structural adjustment pressures constraining recovery. Therefore,

[1]For details, see previous speeches entitled "The role of the Central Bank" and "Recent Monetary and Economic Conditions and Issues facing the Japanese Financial System", given on 14/06/96 and 03/04/96, respectively. Both speeches are included in the August 1996 issue of the *Bank of Japan Quarterly Bulletin*.

to predict future economic developments, we must first understand how these two factors are at work in the economy.

One of the forces encouraging recovery is the permeation of policy effects. For example, there is no doubt that the decline in interest rates has been contributing significantly to the recovery in housing and business fixed investments. At the same time, fiscal expenditures have underpinned domestic aggregate demand. However, forces encouraging economic recovery are not limited to the supporting policy measures. As the economy follows a recovery path supported by policy effects, a larger number of firms with improving profits have begun to show a more positive stance toward business fixed investment and employment. As a result, the risk of a deflationary spiral, which was an issue of concern last year, has been practically eliminated. It can thus be said that the cyclical forces of the economy based on domestic private demand have been slowly but steadily at work for the past year.

However, the factors that constrain economic recovery have also been persistent. For example, while business fixed investment continues to recover owing to progress in capital stock adjustment, it has not yet gained the full momentum seen in past economic recoveries. This is because firms, in spite of improved profits, have given priority to repaying debts in order to improve their balance sheets, or have limited their gross fixed investment to the amount of cash flow generated from depreciation of existing facilities.

Intensified competition with other Asian countries, which has brought changes to the international environment, is also affecting the Japanese economy in various ways. The inflow of low-priced goods from other Asian countries, for example, seriously affects firms producing competing products. Furthermore, the relocation of production bases overseas by Japanese manufacturers not only decreases domestic business fixed investment by those manufacturers, but also restrains the investment by their domestic subcontractors, due to decrease in orders. It seems that management of firms have not been able to dispel uncertainties over the future, as the path toward a new industrial structure remains obscure under the current circumstances.

B. Structural Adjustment Pressures

The Japanese economy is thus faced with two types of adjustment pressures: pressures for balance-sheet adjustment in the corporate sector; and pressures for structural adjustment of the industries created by the intensifying competition with other Asian countries. These are the factors that have caused the pace of economic recovery to remain moderate. These two adjustment pressures are, however, significantly different in nature.

Adjustment of balance sheets is about reducing debts which accumulated during the “bubble” period, in other words, disposing of the burdens from the past. To that extent, this adjustment is regrettably of a negative nature.

In order to reduce the burdens, it will be necessary to enhance the functions of the capital markets to strengthen firms’ capital bases, and to revitalize the real estate market to facilitate the liquidation of firms’ real estate holdings. Ultimately, however, it is only increase in profits that provides the funds necessary to write off latent losses on real estate and repay accumulated loans. In other words, the burdens from the past need to be reduced gradually with each year’s income arising from economic activity.

In this regard, although it may sound paradoxical, revitalizing economic activity and boosting corporate profits, or more fundamentally, supporting the recovery of the economy will be important preconditions for the smooth progress of balance-sheet adjustment. Realizing a recovery of the economy encumbered with impaired balance sheets, therefore, requires a stronger policy support than otherwise. This is one of the reasons why the Bank has implemented substantial monetary easing measures to date.

As a result, the economy has resumed recovery, although moderate, and corporate profits have been increasing. Accordingly, balance sheets have also been improving gradually. Regarding debt servicing ability, the ratio of firms' long-term debts to cash flow has been declining slowly for the past two years, after rising rapidly during the "bubble" period. It can be said that firms' balance sheets have, in general, begun to show steady improvement, although differences remain between individual sectors and firms.

While the balance-sheet adjustment is an attempt to recover from a negative situation, structural adjustment of the industries in response to a new global economic environment is essentially a positive challenge in that the restructuring process itself introduces the possibility of creating renewed economic development.

The increasing supply capacity of other East Asian economies and their transition to market economies have intensified competition facing Japan's labor-intensive sectors. At the same time, however, these factors have expanded markets and business opportunities for the Japanese economy. Therefore, if the Japanese economy can adapt itself successfully to this new international division of labor, these developments should bring significant benefits to the Japanese economy in the long run.

In fact, a careful look at the Japanese economy will reveal indications of such positive industrial restructuring. The change in Japan's trade structure is one example. Until a decade ago, the top five imports were mostly fuels and raw materials, usually crude oil, wood, petroleum products, coal, and natural gas, although the order varied from year to year. In 1995, however, while crude oil maintained its top position, the other four major imports were office machinery, electronic parts, automobiles, and wood. The share of manufactured goods in Japan's total imports has doubled from 30 to 60 percent over the decade. This change by itself would merely suggest that the manufacturing sector, which had long been Japan's mainstay, now faces severer competition with imported goods. What is notable is that the composition of exports has also changed significantly during the same period. Automobiles, ships, and household electric appliances such as television sets and radios used to appear at the top of the list of export items. In 1995, however, while automobiles stayed as the number one import, electronic parts, office machinery, automobile parts, and scientific and optical apparatus ranked second to fifth, indicating that capital goods and parts have replaced consumer durables.

As labor-intensive sectors such as the consumer durables industry grow in other East Asian economies, exports of labor-intensive products from Japan have been declining, while those of capital-intensive products with higher value added, such as capital goods and related parts, have been increasing. This is a typical illustration of the Japanese economy's strong ability to adapt to changes in the global environment.

The emergence and expansion of new leading industries in Japan are also indications of industrial restructuring. The mobile telecommunications market, for example, has grown rapidly to a ¥3.5 trillion market and the business fixed investment of this industry has expanded to almost ¥2 trillion, which is equivalent to the sum of business fixed investment by the automobile and iron-and-steel industries. Furthermore, in these three years when economic recovery has been unable to obtain a firm footing, some industries achieved earnings growth comparable to or even exceeding that attained in the three years during the economic boom of the latter half of the 1980s: namely, the electrical and precision machinery industries, which have succeeded in adjusting to the new international division of labor; and the pulp and paper industry in the raw materials sector, which has been able to benefit from the increased volume of information processed and distributed in today's technological age.

I have so far emphasized the brighter side of the domestic economy with the hope of further encouraging the efforts of domestic industries, but reality is obviously not so simple. During periods of transition of industrial structure, the contrast between the bright and dark sides tends to become stronger. Focusing on the dark side, the mismatch between labor supply and demand has become greater, and restructuring burdens have been particularly heavy on small and medium-sized firms.

Looking back at the postwar period, the Japanese economy successfully underwent several major changes in the industrial structure and shifts in leading industries. There is no doubt that during the periods of transition, management of firms faced great uncertainties about the future, and that it was extremely difficult to accurately predict which would be the growth industries in the coming years. However, during the era of high economic growth, the rapid expansion of the economy absorbed the negative impact arising from the structural adjustment of the industries. The main difficulty that the current economy faces seems to lie not in the industrial restructuring itself, but in the fact that the current economic growth is not strong enough to provide a similar “shock absorber” effect.

For this reason the implementation of structural policy, such as deregulation, has become an urgent issue. In order to promote industrial restructuring, it is necessary to create new investment opportunities and to encourage unrestricted and creative business activity through deregulation. It is also important to increase labor mobility and facilitate land transactions.

C. Economic Outlook and Monetary Policy Management

In order for the Japanese economy to be put firmly on a self-sustaining recovery path in the face of reduced fiscal support, it will be necessary for the structural adjustment to continue to progress and for the virtuous circle between production, income, and expenditure to gain further strength. In this respect, firms have been responding steadily to the structural adjustment pressures. The decline in net exports, which had been a drag on economic recovery, has been slowing recently. In addition, inventory adjustment, which has been under way in certain sectors since this spring, has virtually been completed in the iron-and steel-industry.

In light of these facts, it is most likely that production will be further revitalized, strengthening the virtuous circle of the economy led by expanded private demand. However, this remains to be seen.

In view of this economic situation, the Bank will continue, in the management of current monetary policy, to monitor monetary and economic developments closely, placing emphasis on further strengthening the foundation for an economic recovery. And to repeat my earlier point, it is also important to carry out structural reforms including drastic deregulation. In this respect, I hope that the new administration will continue to exercise strong leadership.

III. New Thinking on Economic Policy Management

The industrialized countries today attach more importance to structural policies, such as the strengthening of the competitiveness of domestic industries and the improvement of market infrastructure. In addition, these countries are making steady efforts to promote fiscal consolidation, to reform their central bank systems, and more broadly, to review national economic policy management and its framework.

This common trend among the industrialized countries is closely related to the recent changes in the global economy. The collapse of the former socialist bloc, for example, demonstrated the superiority of a market economy over a government-controlled economy: that is, the superiority of a decentralized economy over a centrally-planned economy. In addition, the transition to a market economy and the progress of industrialization of these former socialist countries and the developing Asian countries have stimulated the industrialized countries to strengthen the competitiveness of their economies.

Furthermore, past experiences of economic fluctuations, such as inflation and the asset-price “bubble”, and the concurrent accumulation of budget deficits have prompted countries to closely re-examine fundamental thinking on economic policy and the underlying economic theories. This year happens to be the 50th year since the death of John Maynard Keynes. There have recently been renewed discussions on the evaluating of Keynes’ theories and Keynesian economics, which in many respects formed the basis of postwar economic policies.

The approaches currently adopted by various countries in addressing economic policies have several points in common.

The first point is the growing emphasis placed on improving the supply side of the economy. The conventional approach to economic policy emphasizes the control of aggregate demand through monetary and fiscal policies, and this remains dominant when seeking short-term adjustments of the economy. At the same time, however, there is a growing perception that the driving force of long-term economic growth owes much to firms’ efforts to improve their productivity. It is thus necessary to strengthen the supply side of the economy by promoting the introduction of new technology and by improving infrastructures such as transportation and telecommunications.

In fiscal policy management, greater importance is being attached to the details of fiscal expenditures from the viewpoint of evaluating the contribution of each portion to the improvement of economic infrastructures, rather than to their effects in generating additional demand. There is also a stronger awareness that, in the medium to long term, it is more desirable to curtail inefficient fiscal expenditures thereby reducing budget deficits and to utilize economic resources more efficiently in the private sector. All this reflects the growing emphasis on the supply side of the economy.

The second point in common in the approaches to addressing economic policies is the emphasis placed on the utilization of the market mechanism. Related to the first point, it can be said that this emphasis calls for fully utilizing the inherent forces of the market mechanism of promoting greater economic efficiency and of inducing technological innovation, in order to achieve higher productivity.

The global trend toward deregulation and promotion of market competition obviously originates in this common thinking. The effectiveness of the market mechanism is not limited to revitalization of industries and improvement of financial markets. For example, in Europe, there is a growing understanding that the main cause of the high unemployment rate, which has persisted for some time, is the lack of mobility in the labor markets. The solution to the problem, therefore, is considered to lie in facilitating the mobility in the labor markets so as to efficiently adjust labor market conditions.

The third common element is the growing emphasis placed on the public’s expectations regarding future developments and its confidence in economic policies. For example, the effectiveness of fiscal policy depends significantly on the public’s views on the controllability of the fiscal deficits in the future. In the European countries and the United States, there is a growing perception that doubts about a government’s ability to control budget deficits could bring about an unfavorable rise in long-term interest rates. This is one of the major reasons why fiscal consolidation is considered to be an important task.

It has also become clear that changes in expectations regarding price and interest rate developments significantly influence the effectiveness of monetary policy.

There is a theory which even suggests that discretionary economic policy would not have any effect if people always had rational expectations about the future. While this may be an extreme example, in general it has come to be considered that the efficacy of economic policy cannot be discussed without taking into account its effects on people’s expectations.

These recent changes in the thinking on economic policy naturally have a close bearing on the fundamental thinking about central banking and monetary policy management.

For example, even when implementing short-term demand management policy, it is necessary to ensure that the policy is compatible with the objective of price stability -- the medium to long-term objective of monetary policy and a precondition for the smooth functioning of the market mechanism. It is also necessary to ensure that the public's confidence in monetary policy be strengthened by clearly establishing the independence and accountability of the central bank. Bearing these points in mind, I would now like to move on to the other theme of today's speech, the fundamental issues concerning monetary policy management.

IV. The Basic Thinking on Monetary Policy Management

A. Price Stability and the Central Bank

Most people agree that the objective of monetary policy is the maintenance of price stability. I would like to explain why it is that this particular economic policy objective, among others, is assigned to monetary policy.

Price stability, in this context, is not necessarily the stability of prices of individual goods and services, in other words, the stability of relative prices of individual items. In fact, fluctuation of relative prices in response to changes in the supply and demand conditions reflects the most basic principle of the market mechanism. Central banks aim at achieving the stability of prices in general by taking the prices of individual items in their totality. If prices in general increase, that is, if inflation occurs, the amount of goods that can be purchased for ¥10,000 will decrease, which means that the value of ¥10,000 will decline. It can thus be said that "prices in general" is another way of expressing "currency value". The maintenance of price stability naturally becomes one of the most important missions of the central bank as the issuer of the currency, together with the mission of maintaining the stability of the financial system.

Moreover, in the long run, it is the monetary policy of the central bank that is able to most effectively achieve stability of prices in general. It is true that prices, in the short term, fluctuate due to various factors: overseas market prices, such as crude oil prices; or the supply and demand conditions of particular goods. However, from a longer-term perspective, prices in general are determined by the amount of money relative to the amount of traded goods and services. For this reason inflation is often said to be a monetary phenomenon, and the task of achieving price stability is necessarily assigned to monetary policy. This then explains why the monetary policy of the central bank is so vital and why the central bank is called the guardian of the currency.

There is a question of how asset prices, such as land prices and stock prices, may be considered in the management of monetary policy. The Bank believes that it is unsuitable to consider asset prices in the same way as it does the prices of ordinary goods and services. For example, land is not produced by everyday economic activity. In addition, land prices are determined in part by the perception of earnings that will be generated from the land, in other words, by the projection of economic activity and prices. Asset prices are therefore different in nature from the prices of goods and services that are produced daily through economic activity and consumed. It is also apparent, however, from the bitter experiences of the "bubble" economy that major fluctuations in asset prices are related to large swings in the economy. Therefore, the Bank believes that in order to ensure price stability in the medium to long term, due attention must be paid to asset-price developments. Later, I would like to discuss in more detail the meaning of price stability in the medium to long term.

B. The Significance of Price Stability

Let me now consider the significance of price stability. It seems self-evident that inflation and deflation are not desirable. As large fluctuations in prices are usually accompanied by economic overheating or recession, the stabilization of prices will lead to a stable economy. Furthermore, price fluctuations lead to an uneven distribution of income and assets, thereby threatening the stability of people's everyday lives.

In addition to the above, I would like to stress that the stability of prices in general is the most important precondition for the smooth functioning of the market mechanism. The market mechanism adjusts production and demand according to the signals sent by the changes in relative prices. Once inflation or deflation occurs, it becomes extremely difficult to read the signals received from the changes in individual prices, and as a result, the price mechanism ceases to function properly. This is because it becomes impossible to distinguish whether changes in individual prices reflect shifts in relative prices or in prices in general. It is as if there is no reliable yardstick for economic activity. Under such circumstances, firms trying to formulate future business plans based on their estimation of profitability of investments, and households making plans for savings and consumption face growing uncertainties, and this impedes economic development.

In the past, some argued that inflation is desirable to a certain extent in order to further stimulate economic growth, or that firms' activities would become more vigorous under inflation. The 50 years of postwar experience and the evolution of economic theories, however, have forced serious reconsideration of this argument. There is every likelihood that a mild inflation will eventually lead to full-scale inflation. In addition, once inflation takes root, the achievements of business activity are masked by nominal increases in profits, and accordingly, technological innovation and improvement in productivity are likely to be discouraged. Actual examples demonstrate that, from a longer-term perspective, countries with stable prices tend to enjoy higher economic growth.

For these reasons, the current emphasis is on the significance of price stability, which is in line with the global trend in economic policy management placing stronger emphasis on the supply side of the economy and on the utilization of the market mechanism.

C. The Meaning of Price Stability and Assessment Criteria

How can price stability be defined? This remains a difficult question as it is not easy to draw a line between acceptable and an unacceptable rate of price increase.

In theory, zero inflation would be desirable. If prices are to be the yardstick for economic activity, zero inflation allows the yardstick to be reliable and unchanging, and in addition avoids the adverse effects of price fluctuations on income distribution.

I said that this is true "in theory" for several reasons. First, there are limitations to the accuracy of price statistics in that it is difficult to exclude price increases arising from improvements in product quality or to reflect changes in the market share of products. As the statistics become biased due to such technical limitations, some argue that it is undesirable to aim at zero inflation based on a specific price indicator. In addition, if there is a downward rigidity in certain prices and wages due to business practices and contractual constraints, the cost of achieving zero inflation could become substantial.

In view of the significance of price stability as discussed earlier, a more practical criterion would be the sustainability of price stability in the medium to long term. This is because prices serve as a yardstick not only for deciding current production and consumption, but also for deciding the activities that lead to future economic developments, such as business fixed investment and savings. The perception that prices influence future developments has led to an increasing tendency to view price stability as being the state in which firms and households need not consider prospective price fluctuations in their economic decision-making.

Even when price indexes remain stable during a certain period, price stability in the medium to long term could be at risk if the economy is overheating and creating potential upward pressures on prices. Monetary policy must thus be managed not only to minimize current fluctuations in prices, but also to contain the potential risk of price fluctuations in the future. This is why price stability is said to be a medium to long-term objective of monetary policy.

The maintenance of price stability does not conflict with the achievement of stable economic growth and employment conditions. For example, measures to prevent overheating (or recession) of the economy can at the same time contain inflation (or avoid deflation), and provide medium to long-term price stability; and this price stability, in turn, is a prerequisite for achieving sustainable growth of the economy, as I mentioned earlier.

D. Features of Monetary Policy

I would now like to examine the important elements in managing monetary policy.

There are two features of monetary policy that differentiate it from other economic policies. The first feature is that monetary policy uses market-oriented measures to transmit policy effects to market participants and therefore the efficacy of monetary policy depends on the market's reaction to the measures taken by the central bank. In this respect, monetary policy differs significantly in nature from the government's economic policy, which aims to achieve its objectives through administrative means such as laws and regulations.

Specifically, monetary policy affects the supply and demand of funds in the financial markets through the implementation of the Bank's daily operations, such as bill and bond transactions. The mechanism is initiated in changes made to the money market interest rates, or in technical terms, changes to the overnight rates in the interbank market, which can be referred to as the wholesale market for cash and reserves. Changes in these rates affect other short-term interest rates and longer-term rates through arbitrage in the markets, which in turn influence changes in the deposit and lending rates offered by banks. These changes in interest rates as a whole then influence the economic activities of the corporate and household sectors.

With the completion of the deregulation of interest rates, use of the market mechanism is currently the most effective way of transmitting policy effects throughout the financial markets and the economy. However, in order to effectively utilize this mechanism, public and market confidence in monetary policy is of decisive importance. Unless the policy intentions of the central bank are fully understood and considered to be credible, the effects of interest rate policies will not permeate adequately, and market interest rates may fluctuate independently of the intentions of the central bank, affected by unnecessary conjecture and rumors.

The second distinct feature of monetary policy is that considerable time is required before its effects materialize, in other words, there is a long time lag before policy effects permeate throughout the economy.

The mechanism through which changes in interest rates are transmitted to economic activity is complicated. Interest rate changes may have a relatively rapid influence on firms planning to make an investment in the near future. Theoretically, the effect of interest rate changes should be swiftly transmitted to fluctuations in asset prices.

On the other hand, it takes a considerable time for the effects of interest rate changes to appear in actual corporate profits and household income levels. One reason is that there are various types of borrowing and investment with short and long maturities. As new interest rates are applied to these instruments only at the time of maturity, considerable time is required before the overall interest rate level changes and before the new level takes effect throughout the economy. In addition, changes in corporate profits and income levels will only bring about a gradual change in the confidence of firms and households in their investment and consumption, and after some delay in time, new decisions will be made on investment and consumption. Further time is then needed before these decisions materialize as actual spending.

It has been said that pre-emptive policy responses are necessary to ensure price stability. This is because, as mentioned earlier, price stability must be achieved in the medium to long term, and because there will always be a considerable time lag before policy effects permeate throughout the economy. As this time lag in permeation of policy effects has become more widely recognized, greater emphasis has come to be placed in the management of monetary policy on assessing the potential risks in the economy, to enable pre-emptive policy responses.

E. Considerations in Monetary Policy Management

The requirements for monetary policy are thus “maintenance of market confidence” and “pre-emptive response”. It is, however, extremely difficult to achieve these two requirements simultaneously.

Let me explain how the two requirements conflict. In order to make timely policy responses, it will be necessary for the central bank to act based on its projections of the economic and price situations one or two years ahead. However, considering the difficulty of accurately predicting economic developments, such action may not necessarily result in market confidence in the Bank’s policy. Nevertheless, it would be impossible to act pre-emptively if the Bank waited until a consensus was reached on future economic developments and desirable policy actions.

It is no exaggeration to say that the key to monetary policy management is in finding how these two requirements can be fulfilled simultaneously.

Central banks have tried to meet the two requirements through various techniques. For example, many central banks in the past adopted “money supply targeting”, in which monetary policy is aimed at achieving an intermediate target of money supply growth. This is a method based on the causality that fluctuations in money supply influence real economic activity with some time lag. However, it has been pointed out that financial innovations have made it difficult to discern the relationship between money supply and economic activity, and that although the relationship between the two is stable in the long term, it may be unsteady in the short term. Accordingly, many of the central banks which set a money supply target today mainly use it as a general guideline for monetary policy or refer to it as one of the major indicators in making policy decisions, rather than attempting to adhere rigidly to it.

Some central banks now adopt “inflation targeting”, in which a certain target range is set for the inflation rate. This method aims to secure the confidence of the market by declaring beforehand the central bank’s commitment to a specific target. For those central banks employing inflation targeting, another challenge besides setting the target range is devising how to take appropriate, individual policy actions under the price target. Countries with high inflation rates have succeeded in containing these rates by employing inflation targeting. However, the fact that the method has been effective in curbing a high inflation rate does not necessarily indicate that it will also be effective in sustaining already stable prices.

Recently, some academics in the United States have suggested evaluating the potential risks of price and economic fluctuations based on such concepts as the output gap and the expected inflation rate, and then utilizing these evaluations as guidelines in managing monetary policy.

Unfortunately, it is difficult to establish rules or other convenient guidelines which are by themselves sufficient to ensure an optimal policy response. It is for this reason that the Bank of Japan has never adopted stringent targeting or specific rules to date, but instead has consistently emphasized the judgement of the overall economic conditions and has made efforts to improve underlying research and analytical skills.

Learning from the bitter experiences of the emergence and the bursting of the "bubble" economy, the Bank attaches utmost importance to realizing price stability and thereby economic stability in the long run, and, to this end, identifying and assessing the potential risks within the economy. The Bank has also been making increased efforts to explain its actions and policy in detail in order to gain the better understanding of the public.

One of the aims of last year's series of monetary easing measures was to eliminate the possibility of a deflationary spiral, in other words, a potential risk of excessive price declines. The Bank also made efforts to provide a clearer explanation of the details of policies implemented and the thinking behind these policies. Announcements of the Bank's stance on money market operations and improvements in the monthly and annual reports of the Policy Board are results of these efforts.

The Bank intends to continue investigating ways of fulfilling simultaneously the two requirements of pre-emptive policy responses and of the maintenance of market confidence, by learning from theoretical and empirical studies and from the experiences of other central banks.

I would like to emphasize that, in order to maintain market confidence in the central bank which is an essential task for achieving price stability in the medium to long term, the institutional independence of the central bank becomes very important. Accordingly, it will be necessary to enhance the transparency of policy decisions and to establish a framework to ensure the Bank's accountability.

V. Conclusion

The review of the central bank system in Japan is likely to develop into a revision of the Bank of Japan Law after the Central Bank Study Group submits its report.

When seen from the vantage point of reconsidering the broad framework of economic policy, I believe that the revision of the Bank of Japan Law is significant not only to the Bank of Japan itself or to the financial sector, but also to the overall economy. Now that Japan's industries are making steady efforts to adapt to a new era, it is also required that the economic policy management of Japan be reformed to suit the times.

The Bank of Japan Law is to be reviewed as the first concrete step in the reform process of Japan's economic policy management. The law, stipulated in 1942, has been one of the rules and regulations constituting the basis of the old regime which has affected the country's economic policy management for the past 50 years. This is why much international attention is now focused on the reform of the central bank system in Japan.

In order for the central bank to achieve its missions, improvement of the institutional framework is necessary, but what is more important is that the Bank manages its policy and operations with due responsibility. We at the Bank are very conscious of this and will exert ourselves to the utmost to ensure that the Bank fulfills its responsibilities amid the ongoing globalization and shifts to market-oriented economies. I would like to conclude by expressing my hope for your continued support and understanding.