Excerpts of a Speech Given by Kazumasa Iwata, Deputy Governor of the Bank of Japan, at a Meeting with Business Leaders in Niigata on March 7, 2007

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Bank of Japan

Introduction

Today, as a representative of the Bank of Japan, I am pleased to have this opportunity to present the Bank's view on the current state of the Japanese economy and its outlook. I would also like to explain the Bank's decision to raise the policy interest rate at its Monetary Policy Meeting (MPM) in February as well as the thinking behind its conduct of monetary policy.

I. Overseas Economic and Financial Developments

Let me start with overseas economies. In the United States, the economy expanded at an annual rate of 2.0-2.5 percent over the last three quarters with housing investment continuing to cool significantly. However, spillover effects from the housing adjustments have been limited, and private consumption has continued to show solid growth. As for price developments, the rates of increase in the core consumer price index (CPI) and in the core personal consumption expenditure (PCE) deflator have been at relatively high levels.

Both upside and downside risks currently coexist in the U.S. economy, surrounding the inflation situation and the economic growth rate, respectively. Nevertheless, given the robustness and the flexibility of the economy it is likely to avoid a significant slowdown in the growth rate and to realize a soft landing, returning to its potential growth path from the current 2.0-2.5 percent by late 2007, with a gradual decline in the rate of inflation.

In the euro area, economic recovery continues to be solid, while in China and India strong expansion is continuing on the back of growth in demand both at home and abroad. Overseas economies taken as a whole continue to exhibit strong growth. At the G-7 meeting held about a month ago, there was a consensus view that the world economy is likely to keep expanding with more balanced growth.

Turning to global financial markets, a plunge in the Chinese stock market at the end of February resulted in large fluctuations in stock prices worldwide and higher volatility in asset prices. Up until then, volatility in asset prices had been very low internationally, resulting in tighter credit spreads and smaller term premiums. With investors appearing "overly complacent" about asset price changes and various other risks, a situation developed in which investors focusing on the interest rate differential between Japan and abroad favored the yen carry trade. Recently, however, there has been some unwinding of this trade. Although these adjustments seem so far to have been limited basically to technical corrections in position-taking by those who felt overexposed, careful attention should be paid to whether the higher volatility in asset prices may have some implications for investors' risk-taking behavior in the future.

II. Developments in Japan's Economy

Against the background of the strong growth in overseas economies, Japan's economy has been experiencing a sustained period of moderate expansion. The economy maintained a rate of growth of about 2 percent from fiscal 2003 to fiscal 2006, a pace which it seems likely to sustain during fiscal 2007.

A. Slow Permeation of Strength in the Corporate Sector through to the Household Sector

The current economic expansion is now six years old, but partly because of the gradual pace of growth, it is not making itself felt by households to the same extent as in past economic expansions.

In the corporate sector, however, corporate profits have been favorable and business fixed investment is growing at a rapid pace, especially among manufacturers. Corporate profits and business fixed investment are expected to keep increasing steadily, and this suggests that the engine of the economic expansion remains intact.

Despite the strength in the corporate sector, the pace at which this positive influence has filtered through into the household sector has been slow. Faced with intensifying global competition and greater exposure to the discipline of the capital market, corporate management has been increasing the emphasis it places on raising profitability.

Reflecting these factors, growth of wages has been modest. Especially since summer 2006, the effects of the baby-boomers' retirement and of cuts in personnel expenses for local civil workers are exerting additional downward pressure on the growth of wages per person.[1] The modest increase in wages seems also due to management's greater efforts to reduce fixed costs to cope with sharp rises in prices of crude oil and other materials from 2004 through fall 2006, and employees' preference for employment stability over a wage increase after their past experiences of a severe employment situation.

With regard to the employment situation, the number of employees has continued to increase steadily at an annualized rate of slightly over 1 percent, and labor market conditions are gradually becoming tighter. The unemployment rate for women was 3.8 percent in January 2007, lower than that for men (4.1 percent), and women's wages have been increasing steadily since 2005. Hourly wages for part-time workers have posted year-on-year increases since 2003, and the rate of increase rose gradually through 2006. Looking forward, wages, including those for men, are expected to rise steadily as labor market conditions become increasingly tight.

With the number of employees increasing steadily, household income has continued rising moderately and private consumption has been firm. A more distinct upward momentum in private consumption is likely to emerge as the adverse effects from temporary factors -- such as last year's weather conditions (a long spell of rainy weather in early summer as well as the unseasonably warm winter weather) and consumers' reluctance to buy before the introduction of new products -- fade and wages resume their upward trend reflecting improved labor market conditions.

[1] The modest growth of wages, despite increased demand for labor, can be attributed to the flexibility of the labor supply, witnessed for example in an increase in the rate of female participation in the labor force.

B. Production and Inventory Adjustments

Production exhibited high quarter-on-quarter growth of 2.6 percent in the October-December quarter of 2006, but a downward reaction to this high growth coupled with adjustments in the IT-related sector will likely suppress growth in the January-March quarter of 2007. Unlike inventory adjustments in IT-related goods during 2002-03 and 2004-05, adjustments this time seem largely due to weaker-than-expected demand for cellular phones and new game consoles, although the impact of the introduction of a new personal computer operating system has still to be fully ascertained.

C. Developments in Consumer Prices

The year-on-year rate of change in the CPI (excluding fresh food) was flat in January, and depending on developments in crude oil prices and foreign exchange rates, it may turn slightly negative in the short term. From a longer-term perspective, however, consumer prices are expected, over time, to display trend increases given that the economy has expanded at an annual rate of around 2 percent over the last four years and that the expansion is expected to be long-lasting. With the continuing economic expansion, the utilization rates of production capacity and of labor have been rising steadily, and they are expected to increase further. As the recent *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicates, corporate managers are increasingly feeling shortages of production capacity and labor, while a positive output gap suggests that demand currently exceeds supply in the economy as a whole.

Since autumn last year, upward movement in the CPI has been subdued partly because of sluggish growth in private consumption and wages. However, the CPI is expected to resume a moderate upward trend as the effects of the drop in crude oil prices fade out. When considering the effects of the fall in crude oil prices, we should note the consequential improvement in Japan's terms of trade and concomitant decrease in the amount of wealth transferred to oil-producing countries, which will boost private consumption in Japan by improving households' real income through higher corporate profits and lower prices.[2]

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[2] The significance of the transfer of wealth to oil-producing countries can be approximated by the difference between the growth rate of the GDP deflator and that of the domestic demand deflator. Based on this estimation, the transfer of wealth accounted for on average about 0.7 percent of nominal GDP from 2004 through 2006. If this wealth were not transferred to oil-producing countries

III. Decision at the MPM in February

Based on the "New Framework for the Conduct of Monetary Policy" announced in March 2006, the Bank examines future risks from two perspectives.

The first perspective examines the prospects as well as risks for the economy and prices basically within a projection period of one and a half to two years. At the MPM held in February, it was judged that Japan's economy "is likely to continue its moderate expansion with a virtuous circle of production, income, and spending in place." It was also judged that although the year-on-year rate of change in the CPI (excluding fresh food) may register around zero in the short run, depending, for example, on developments in the prices of crude oil, it is likely to "increase as a trend" given the expected continuation of the economic expansion.

The second perspective extends the horizon beyond that of the above forecasting period and takes into account various risks that would significantly impact the economy should they materialize, even though the probability of such materialization may be low. At the February MPM, it was noted that "[i]f expectation takes hold . . . that interest rates will remain low for a long time regardless of economic activity and prices, there is a possibility that sustained economic growth will be hampered by misallocation of funds and resources through excess financial and economic activities."

Based on its assessments from these two perspectives, the Bank has decided to change the guideline for its money market operations so as to encourage the uncollateralized overnight call rate to remain at around 0.5 percent. At the same time, the basic loan rate applicable under the complementary lending facility (the standby lending facility through which the Bank will extend a loan at the request of a counterparty up to an amount not exceeding the value of that counterparty's collateral) was set at 0.75 percent. With respect to the outright purchases of long-term interest-bearing Japanese government bonds, the Bank has decided

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but instead spent in Japanese markets, it could be expected to deliver a positive fillip to the growth of domestic demand. For details, see K. Hamada and K. Iwata, "National Income, Terms of Trade and Economic Welfare," *Economic Journal*, Vol. 94, December 1984.

that purchases will continue at the current amount and frequency for some time.

With regard to the future course of monetary policy, the Bank stated that it will adjust the level of interest rates gradually in the light of developments in economic activity and prices, while maintaining the accommodative financial conditions ensuing from very low interest rates for some time.

IV. Thinking behind the Conduct of Monetary Policy

It takes quite a while for the effects of a monetary policy change to filter through to the economy and prices. Because of the long and variable lag length, the conduct of monetary policy needs to be forward looking, based on the outlook for the economy and prices over a sufficiently long term.

The Bank releases the *Outlook for Economic Activity and Prices* (the Outlook Report) semiannually, in which it describes its forecast for the economy and prices over a horizon of one and a half to two years. The Bank's conduct of monetary policy is based on this forecast. It has become a common practice among central banks to conduct monetary policy based on published forecasts for economic activity and prices.

The key point of a "forward-looking policy framework" is to conduct policy on the basis of a forecast of the most likely outlook for the economy and prices, as well as identification of the accompanying upside and downside risks, by conducting a careful analysis of incoming indicators and other relevant data. Especially in cases where the implications of the available data are mixed, the accuracy of the forecast should be carefully examined in making policy decisions. Coming to a decision through painstaking examination of the available economic data and other relevant information, therefore, is the basis of forward-looking monetary policy. Arguments that treat the assessment of available data and the conduct of forward-looking monetary policy independently of each other are incompatible with the basic reasoning behind the Bank's new policy framework.

Reviewing the forecasts presented in the October Outlook Report in January, it was judged that Japan's economy and prices had so far deviated slightly below the outlook forecasts, but that economic expansion was likely to continue under price stability. Although at the January MPM many members said that they were not confident enough about the outlook to prescribe a policy change, at the February MPM, after examining all available data, most Policy Board members were able to reaffirm that the virtuous circle of production, income, and spending remained intact. This increased their confidence in the outlook for economic activity and prices, and therefore the decision to raise the target rate was taken.

In the "New Framework for the Conduct of Monetary Policy," it is stated that Policy Board members will conduct monetary policy in the light of their understanding of what constitutes medium- to long-term price stability. Taking account of the actual measurement bias in the CPI and Japan's history of low inflation, an approximate range between 0 and 2 percent in terms of the year-on-year rate of change in the CPI is generally consistent with the individual distributions given by Policy Board members to describe their own understandings of medium- to long-term price stability.[3] The range includes 0 percent, but this does not mean that the Bank is conducting monetary policy to achieve zero percent inflation. On the contrary, it should be noted that most Policy Board members' median figures fell on one side or the other of 1 percent.

As I have stated earlier, the rate of change in the CPI may temporarily be around zero or even slightly negative in the short run depending on developments in the prices of crude oil. Also, it is possible that the sensitivity of prices to higher rates of domestic resource utilization may have been reduced due to the progress of economic globalization. Meanwhile, a fall in crude oil prices may contribute to the continuing economic expansion, since it would improve Japan's terms of trade, thus boosting real wages and private consumption.

What is important in terms of the forward-looking monetary policy is the basic trend of inflation. Under the assumption that overseas economies are to continue their expansion and

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[3] It is important for the "understanding of medium- to long-term price stability" to become common knowledge among market participants as well as among Policy Board members, and be a focal point in terms of communication policy, as this will in turn facilitate consensus-building among the public. For more details, see K. Iwata and M. Fukao, "Keizai Seido no Kokusaiteki Chosei (International Adjustment of Economic Systems)," Nihon Keizai Shimbun, Inc., 1995.

that the growth mechanism underpinning the domestic economy is firmly maintained, trend increases in the CPI are likely to take hold in the long run, as the influence of declining crude oil prices fades. In any event, it is important to make an effort to achieve price stability in the medium to long term based not on short-term fluctuations in prices but on forecasts for the economy and prices from a sufficiently long-term perspective.

There has been criticism that dialogue between the Bank and financial markets has not been smooth. Central banks need to carefully explain to market participants and the public the basic thinking behind their monetary policy conduct and their assessment of the economic and financial situation. Through careful explanation of these two points, not only will the transparency of monetary policy conduct be ensured but the effectiveness of the policy will be enhanced.[4]

Market participants form expectations regarding future interest rates by adjusting their views on the economy and prices on the basis of information provided by the central bank. Meanwhile, central banks deduce market participants' views on the economy and prices from movements in market interest rates or shifts in the yield curve. Dialogue with markets thus constitutes a two-way exchange of information. The key point here is that central banks provide information concerning the basic direction of monetary policy but do not specify the timing of an actual policy change.

At an MPM, the Policy Board members discuss the current and future state of the economy and prices based on the latest data and information to have become available by the time of the meeting. It is therefore impossible to inform markets of the timing of the policy change in advance. Even if it were possible to do so, the result would be to deprive the Bank of the

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[4] On the subject of the Bank of England's policy regarding communication between itself and financial markets, Governor Mervyn King, in his speech, said that central banks should provide markets with two key pieces of information -- the objective of monetary policy and the central banks' analysis of and outlook for the economy -- to facilitate the formation of market expectations regarding the path of future policy rates. However, he disapproved of providing direct hints about the path of interest rates, since the results of specific policy decisions regarding interest rates remain unknown until after voting within the policy committee has taken place. For details, please refer to the speech by Mervyn King, Governor of the Bank of England, at the Lord Mayor's Banquet for bankers and merchants of the City of London at the Mansion House on June 21 2006.

benefit of information that it could have gleaned from markets. It is desirable that dialogue between the Bank and markets be left to take place as free as possible from noise and distortion.