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Bank of Japan

The Current Situation and Outlook for Japan's Economy
and the Conduct of Monetary Policy

*Summary of a Speech at a Meeting with
Business Leaders in Ishikawa*

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I. The Current Situation and Outlook for Japan's Economy

A. The Current Situation

Japan's economy has remained on a moderate but sustained path of expansion since 2002. However, as you may know, the growth momentum has weakened somewhat against the background of the surge in materials prices, such as crude oil prices, and weaker growth in exports due to the deceleration of overseas economies.

In the April-June quarter of 2008, real GDP decreased by 0.6 percent compared with the previous quarter, marking negative growth for the first time in the past four quarters. Looking at the different components, the growth contribution of net exports, which had been the driving force of the economy, was zero, while domestic demand overall registered a decline mainly reflecting a decrease in private consumption (Chart 1 (1)). Real domestic income has decreased against the background of the deterioration in the terms of trade, and this weakening in real income seems to have slightly weakened the virtuous circle of growth in production, income, and spending. At the Monetary Policy Meeting (MPM) held on August 18 and 19, 2008, the Bank of Japan revised downward its assessment of the state of Japan's economy to "economic growth has been sluggish" from its July assessment that "economic growth is slowing further." However, I would like to emphasize that the economic slowdown has not come all of a sudden. Of course, if we look at the quarter-on-quarter real GDP growth rate, we gain the impression that the economic slowdown has suddenly become more severe, but it should be borne in mind that GDP statistics tend to show large fluctuations. Given the weakening growth momentum, it is clear that "economic growth has been sluggish," but the economy is unlikely to experience a significant adjustment similar to that in 1998 and 2001 because there is no excess in inventories and production capacity. Looking at the real GDP growth on a year-on-year basis (Chart 1 (2)), it becomes much clearer that the slowdown

of Japan's economy so far has been moderate, and this trend is much closer to my perception of developments in the state of the economy.

At any rate, in projecting the future course of Japan's economy, it is now even more important to carefully determine whether the economy will become more sluggish, or whether it is appropriate for the Bank to keep the current baseline scenario that the economy will gradually return to a growth path as energy and materials prices regain stability. With this in mind, let us now look at recent economic developments in more detail.

First, starting off with Japan's exports, which have been the driving force of Japan's economic growth, growth in real exports turned negative in the April-June quarter of 2008 reflecting the decrease in exports to the United States and the European Union (EU). This decrease was caused by the continuing adjustment in the U.S. housing market and disruptions in global financial markets, both of which stemmed from the U.S. subprime mortgage problem. Export growth turned positive again in July against the background of global economic expansion led by emerging economies (Chart 2), but the pace of increase in exports as a whole has slowed (Chart 3). As for developments in overseas economies forming the background to trends in Japan's exports, in the United States private consumption has been sluggish due to, for example, tightened lending standards on consumer loans, a rise in the unemployment rate and a fall in the number of the employed, the negative wealth effect, and the rise in gasoline prices. In particular sales of automobiles, which account for a large share of Japanese exports to the United States, have been sluggish. With regard to the economy of the euro area, growth in the volume of retail sales has been negative for three quarters in a row since the October-December quarter of 2007, and real GDP declined slightly by 0.2 percent on a quarter-on-quarter basis in the April-June quarter of 2008. Meanwhile, in Asian economies such as South

Korea and Taiwan, there have been growing concerns regarding downside risks to domestic demand caused by the deterioration in the terms of trade.

Turning to domestic demand, the deterioration in the terms of trade caused by the surge in energy and materials prices has started to weigh on business fixed investment and private consumption. Corporate profits are decreasing, particularly at small firms. According to the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan), current profits for fiscal 2008 are projected to drop for the second straight year in all sectors, after decreasing for the first time in six years in fiscal 2007. In this situation, business fixed investment has recently been more or less flat. Moreover, the deterioration in the environment for corporate profits, particularly for small firms, is also negatively affecting the labor market. According to the *Labour Force Survey*, the number of employees at large firms in the April-June quarter of 2008 exceeded that of the previous year, but on the other hand, at small firms, the rate of decline has accelerated. Thus, growth in the number of employees, which had supported the steady growth in employee income, seems to be somewhat sluggish. At the same time, the pace of increase is gradually slowing in nominal wages per employee, whose year-on-year rate of change has been positive since the beginning of the year. As a result, nominal employee income has been more or less flat recently and real employee income -- that is, employee income adjusted for inflation -- has started to decline. Given this income environment, private consumption has also been relatively weak. Meanwhile, housing investment has been on a recovering trend since the beginning of this year after having dropped substantially since last year due to the effects of the coming into force of the revised Building Standard Law. However, it has recently remained at levels lower than those prior to the enforcement of the revised law, reflecting sluggish sales of condominiums. Against the background of these developments in domestic and external demand, industrial production

has also continued to be more or less flat since the January-March quarter of 2008.

As for developments in prices, the year-on-year rate of change in the domestic corporate goods price index (CGPI) rose to 7.1 percent in July 2008, the highest level since January 1981 in the aftermath of the second oil crisis. The year-on-year rate of increase in the consumer price index (CPI; excluding fresh food) also rose, reaching 1.9 percent in June against the background of the increase in prices of petroleum products and food. This was the highest rate of increase in 15 years and six months, if we disregard fiscal 1997, when the consumption tax was raised. Given that Japan has experienced a long period of zero inflation, the extent of the increase is considerable. Meanwhile, many firms have been finding it difficult to absorb higher materials prices by increasing productivity and restraining personnel costs and thus since the second half of 2007 have begun to pass on the rise of materials prices to sales prices. Since the price rises are notable especially in the case of daily necessities, whose price elasticity of demand is relatively low, the public's perception of the rate of inflation may be higher than the actual CPI figures. However, growth in wages has been sluggish and price rises have largely been confined to energy and food, suggesting that so far there have been no second-round effects whereby inflation and wages rise in tandem.

B. Outlook for Japan's Economic Activity and Prices

Next, I would like to talk about the outlook for Japan's economic activity and prices. At the MPM in August 2008, Policy Board members agreed that the current baseline scenario for Japan's economic activity and prices was that the economy was likely to "return gradually onto a moderate growth path as commodity prices level out and overseas economies move out of their deceleration phase" and that the CPI inflation rate (excluding fresh food) was

likely to "be somewhat higher over the coming months but to moderate gradually thereafter." Given that the most recent assessment of the economy was that "economic growth has been sluggish," this scenario may give the impression that the Bank is rather optimistic regarding the future course of Japan's economic activity and prices. Let me note here, however, that the Bank's projection is made for the purpose of conducting monetary policy. The Bank makes projections for a relatively long time horizon and refers to indicators released daily and market developments to examine the probabilities associated with the projections. On the other hand, market participants use indicators released daily and market developments to make the projections themselves, and therefore their projections might differ from the Bank's. What I would like to emphasize here is that, so far, the Bank's baseline scenario has not deviated significantly from its previous assessments.

I would now like to focus on individual components, taking into account issues that will play an important role in shaping the future course of Japan's economy, namely (1) developments in overseas economies and global financial markets, and (2) the relationship between inflation and wages.

1. The outlook for economic activity

In assessing the prospects for Japan's economy, developments in the U.S. economy are key because of their effect on Japan's exports and on global financial markets. The rate of real GDP growth in the United States for the April-June quarter of 2008 was firm at around 2 percent on an annualized quarter-on-quarter basis, supported mainly by active countermeasures such as a series of policy rate cuts by the Federal Reserve since last year and a tax relief program by the U.S. government. Given that there were widespread concerns in spring this year that the U.S. economy in the first half of 2008 might register two consecutive quarters of negative growth, the relative firmness in real GDP

growth reassured markets that had grown increasingly pessimistic. Moreover, corporate profits have deteriorated only in particular sectors such as the financial and consumer sectors so far, and gasoline prices, whose rise has been negatively affecting private consumption, have recently been on a decline. On the other hand, adjustments in the housing market are likely to persist as inventories in the housing market remain high, and it is still too early to view future developments in global financial markets optimistically. In this situation, the tightening of lending standards by financial institutions and the deterioration in consumer sentiment are likely to keep exerting downward pressure on private consumption. It is premature to judge how long various measures implemented to support the U.S. economy since last year -- such as policy rate cuts as a result of which real interest rates are now negative, tax relief measures, and financial support for U.S. government-sponsored enterprises (GSEs) -- continue to be effective. However, a further slowdown in the U.S. economy during the second half of fiscal 2008 now seems inevitable. For this reason, Japan's exports to the United States are likely to remain sluggish for the time being. Japan's exports to the euro area and Asia, especially the NIEs and the ASEAN economies, are also likely to be relatively weak for the time being, as not only deceleration in growth in the global economy but also the weakening of real income caused by the rise in international commodity prices further gradually restrains growth in these economies. Therefore, with the slowdown in global economic growth, growth in Japan's exports taken as a whole is likely to be moderate.

Growth in private consumption is also likely to be sluggish for the time being, due to the rise in energy and food prices. From a relatively long-term perspective, however, private consumption is likely to gradually regain firmness as energy and food prices stabilize with the slowdown in the global economy and real employee income improves moderately. Housing investment, whose recovery has recently stalled, is expected to be more or less flat for the time

being, given that sales of condominiums have been sluggish due to expectations of falling prices and the postponement of construction starts against the background of high building materials prices. As for business fixed investment, large firms, mindful of intense global competition, have maintained a proactive investment stance, and according to a recent survey conducted by a private entity, firms' long-term growth expectations have not deteriorated significantly. Both of these circumstances suggest that with the decline in energy and materials prices, which have been eating into profits, business fixed investment is likely to become correspondingly firmer. Meanwhile, production, which currently lacks momentum, in the July-September quarter of 2008 is likely to decline for the third quarter in a row. However, given that the balance between inventories and shipments has not deteriorated significantly, production is expected to return to an increasing trend as the effects of high energy and materials prices dissipate and real income improves.

2. The outlook for prices

I will now move on to the outlook for price developments. Recently, there have been positive comments from private-sector economists and foreign institutional investors that Japan's economic performance has been relatively favorable given the global inflation pressure. In fact, downstream prices in Japan seem to be less affected by the rise in international commodity prices than those in other advanced economies. Let us examine why global inflation pressures have hardly been passed on in Japan.

I believe the key to this lies in the restrained wages in Japan. At a meeting in Saga in January 2007, I discussed the sluggishness in wages per worker in detail and mentioned four important factors behind it. They were (1) the replacement in the labor force of the high-salaried baby boomer generation by low-salaried new graduates, (2) poor corporate performance as a result of intensifying

competition with inexpensive imported goods, (3) firms' increased focus on profits due to the higher ratio of shares held by foreign investors as a result of globalization, and (4) subdued demands by labor unions for wage increases at the cost of securing employment. Let me note here a point raised in the *White Paper on the Labour Economy 2008*, released by the Ministry of Health, Labour and Welfare, as a fifth factor explaining the sluggishness in wages in Japan, namely, the decrease in the number of employees in the manufacturing sector, where productivity is high, and the increase in the number of employees in the service and retail sectors, where labor productivity is low. The impact of the first and second factors on wages seems to have weakened, but the remaining ones are structural wage-restraining factors that continue to operate. In this respect, the situation in Japan differs significantly from that in the United States, Europe, and emerging economies, where there is a strong tendency for wages to move in line with the inflation rate. Since the rise in energy and food prices would lead to a decline in households' purchasing power given this restraint on wages, it is difficult for firms downstream to pass on price rises.

Because of the structural restraint on wages that I mentioned, the outlook for prices in Japan ultimately greatly depends on developments in energy and food prices. It is my view that international commodity prices, which are likely to trend moderately upward in the long run, are likely to regain stability in the short run, due to the slowdown in the global economy. Recently, the slowdown in the U.S. and European economies has been becoming increasingly evident and an increasing number of central banks, including those of emerging economies, have started to raise their policy rates. Moreover, energy prices in some countries have been pushed up by reductions in government energy subsidies. The effects of monetary policy tightening in these economies, together with the restraint on demand through the price mechanism, are likely to promote an adjustment in international commodity prices. In fact, signs of an adjustment in international

commodity prices can already be seen. The spot price of West Texas Intermediate (WTI) crude oil, for example, has recently declined by around 20 percent from the peak reached in mid-July. It will take some time, however, for the adjustment in international commodity prices to be reflected in developments in the CPI in Japan. Therefore, the year-on-year rate of change in the CPI (excluding fresh food) may remain above 2.0 percent for a while, but the pace of increase is likely to decline gradually.

C. Upside and Downside Risks to Japan's Economy

The outlook I just outlined represents the most likely projection based on the information currently available, but of course, it entails uncertainties. Risks to Japan's economy that need to be monitored closely include the upside risks to inflation caused by the rise in energy and materials prices and the downside risks to economic growth stemming from the slowdown in the global economy and the weakening of real income.

1. Upside risks to inflation

Starting off with the upside risks to inflation, as I said, the Bank's baseline scenario regarding prices is based on the projection that international commodity prices, particularly crude oil prices, will gradually regain stability due to the slowdown in the global economy. However, it remains highly uncertain whether crude oil prices (WTI), which are currently in an adjustment phase, will not spike up again, and whether the current adjustment will result in lower increases in the CPI (excluding fresh food) as expected. In fact, market participants' views regarding the outlook for crude oil prices are widely dispersed (Chart 4). The reason I have been focusing more on the upside risks is that the financial environment has been globally accommodative. At the international conference held in May 2008 at the Bank, Professor John Taylor of Stanford University raised thought-provoking points regarding the current situation,

saying, "A key principle of good monetary policy is that interest rates should increase by more than the increase in inflation, after appropriate smoothing out of clearly temporary price changes However, during the past year, as global inflation has risen, global short-term interest rate targets set by central banks have not increased on average by as much as inflation; indeed the global average of these interest rate targets has actually fallen since last summer." In other words, Professor Taylor suggests that the surge in international commodity prices since last year was due in part to an increase in global demand stemming from an accommodative global financial environment.

The policy rate cuts by the Federal Reserve since last summer, which Professor Taylor also referred to at the international conference, were countermeasures to the turbulence in global financial markets stemming from the U.S. subprime mortgage problem. Federal Reserve Chairman Ben S. Bernanke, in his Congressional testimony on July 15, 2008, said that "helping the financial markets to return to more normal functioning will continue to be a top priority of the Federal Reserve." At the meeting on August 5, 2008, the Federal Open Market Committee decided to keep its target for the federal funds rate at 2 percent given that financial markets remained under considerable stress. This has the result that the financial environment in oil-producing and other countries that have pegged their currencies to the U.S. dollar also remains accommodative. Although, as I mentioned earlier, more and more central banks are moving toward monetary tightening, given the high rate of inflation in each economy, the tightening may not be sufficient on a global basis in terms of the Taylor rule. Therefore, upside risks to inflation still remain under the current global financial environment.

Given this situation, there are also growing upside risks to the rate of inflation expected by the public as a result of the persisting rise in prices of daily

necessities such as gasoline and food. According to the results of the *34th Opinion Survey on the General Public's Views and Behavior* conducted by the Bank in June 2008, the proportion of respondents who expected that prices "will go up" increased, accounting for 88.9 percent. Projections made by firms are also important as they set the prices at which goods are sold, and according to the *198th Business Survey of Small and Medium Enterprises in Japan* conducted by Japan Finance Corporation for Small and Medium Enterprise, the diffusion index for sales prices for small firms, which have found it difficult to pass on price rises, has risen for three quarters in a row and is likely to rise for the next two quarters. Moreover, the diffusion index for sales prices for small firms in the *Tankan* conducted by the Bank recently has also shown a rise. Although nominal wages per worker have not risen markedly so far, this does not mean that the relationship between wages and increases in the CPI has disappeared (Chart 5). If firms continue to pass on increases in materials prices and consumer prices keep on rising, it is possible that the pace of increase in wages will gradually accelerate correspondingly and the synergistic upward trend of inflation and wages will become stronger than expected. In a situation where the global financial environment continues to be accommodative, inflation rates worldwide have been rising and households' and firms' inflation expectations are moving upward. Therefore, inflationary risks still warrant considerable attention even though international commodity prices have entered an adjustment phase.

2. Downside risks to the economy

I will next talk about downside risks to the economy. First, let me look at the relationship between downside risks to the economy and the inflation risks that I mentioned earlier. If, as we at the Bank expect, the slowdown in the global economy leads to stability in international commodity prices, corporate profits and real income will cease deteriorating, contributing to sustainable growth of Japan's economy. Such a slowdown, at the same time, may negatively affect

Japanese exports to some extent. Indeed, the decrease in real exports during the April-June quarter of 2008 seems to be partly due to the slowdown in the global economy. It is therefore important to properly assess, from a longer-term perspective, negative factors such as the impact on exports, and positive factors, such as the improvement in real income through the stabilization in energy and food prices.

On the other hand, international commodity prices may start rising again even as the global economy decelerates, leading to an unexpectedly jump in the inflation rate. If this were the case, it would have a greater negative impact on Japan's medium- to long-term growth: this would lead to a further deterioration in the terms of trade and consequently a further weakening of corporate profits and real income; it would also cause a further downturn in the global economy, eventually damaging exports. Countries with growing fiscal and current account deficits in particular could suffer from serious problems such as significant declines in their currency and stock prices. Furthermore, to the extent that inflation would rise, monetary policy would need to be tightened, which would cause a sharp downswing in the growth rate. Thus, upside risks to inflation are at the same time downside risks to the economy.

Developments in global financial markets could also become downside risks to the economy. Widening spreads for subprime residential mortgage-backed securities (RMBSs), asset-backed securities (ABSs), collateralized debt obligations (CDOs), and other securitized products continue to generate strong concerns over further losses and capital base shortages at U.S. and European financial institutions. With regard to GSEs that have suffered from financial weakness, measures such as those included in the Housing and Economic Recovery Act of 2008 were insufficient to silence calls for the injection of public funds, and their stock prices have continued to fall. Since the beginning of the

year, there have been sporadic failures among regional banks. More recently, disputes regarding the buyback of auction rate securities (ARSs), which are suffering from poor market liquidity due to the downgrading of monoline insurers and the worsening financial position of local governments, have added to the concerns over the expansion of balance sheets and fears of further losses at financial institutions. Under these circumstances, according to the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, banks have been tightening their lending standards even on consumer loans and prime residential mortgages. There are concerns that this may lead to a negative feedback loop between economic and financial conditions in that these developments, together with deteriorating sentiment and the negative wealth effect, will hurt the real economy, which would inflict further damage on financial institutions and global financial markets. In money markets in the United States and Europe, the LIBOR-OIS spread remains wide, reflecting the strong demand for U.S. dollar funds.

Financial markets in Japan have been less volatile than those in the United States and Europe, but sentiment remains nervous. Stock prices are showing substantial swings, taking their cue from developments overseas. Similarly, in the credit market, reflecting defaults on publicly issued corporate bonds for three consecutive months since June and an increase in bankruptcies, particularly in the construction and real estate sectors, spreads on corporate bonds with low credit ratings have been widening gradually, but have remained much lower than in the United States and Europe. Given that the book-closing for the first half of the fiscal year at the end of September is approaching, developments in Japanese financial markets, including the money market, will need to be monitored closely.

D. Conduct of Monetary Policy for the Immediate Future

The outlook for the economy and prices remains highly uncertain given

continuing nervousness in financial markets and unclear prospects for international commodity prices and overseas economies. The Bank, while continuing to ensure the smooth functioning of the money market, will carefully assess the outlook for economic activity and prices, the likelihood of its projections materializing, and factors posing upside or downside risks, and will conduct policy accordingly and in a flexible manner. When examining risk factors, the issue is not one of either economic growth or price stabilization. As I have already mentioned, in an environment where the direction of international commodity prices is unclear, upside risks to inflation and downside risks to the economy cannot be dealt with separately.

In the September 2008 issue of the *Financial Markets Report*, the Bank pointed out that the growing inflationary concerns due to the continued rise in international commodity prices increased the uncertainties about the future steering of monetary policy and the macroeconomic environment, and hence reduced market participants' risk appetite further. Increased uncertainty stemming from inflation concerns makes economic decision-making difficult not only for investors, but also for households and firms. To put it another way, it is vital that prices are kept stable to achieve greater economic efficiency and sustainable economic growth. To this end, inflation expectations must be securely anchored. Only then can a central bank take flexible action in the face of a crisis. A key responsibility of a central bank thus is to be ready to confront inflation risks at all times.

II. Terms of Trade and Monetary Policy

As I outlined earlier, developments in resource prices are having substantial effects on the current situation of, and outlook for, Japan's economy. While I have already talked about the Bank's conduct of monetary policy for the immediate future taking into account the implications of resource prices, I would

now like to discuss in greater detail the relationship between the Bank's monetary policy and the terms of trade. In particular, I would like to focus on three points: (1) the need for a global perspective; (2) details of the deterioration in the terms of trade; and (3) the unavoidable burden on the public.

A. The Need for a Global Perspective

The first point is the need for a global perspective. I mentioned earlier that a background aspect to the surge in resource prices was global monetary easing. That is, given the constraints on resources, global demand for resources was too strong because global economic growth was too high. Therefore, if we look at the world as one country, what would be desirable in order to ensure continuing sustainable growth under price stability is a tightening of monetary policy. Such monetary tightening would bring down the economic growth rate to an appropriate level, thereby restraining demand for resources and hence lowering resource prices. This would stabilize the inflation rate, bringing about stable economic growth in the medium to long term.

In reality, however, the world is not one country. Based on a system of floating exchange rates, each country conducts its own monetary policy aimed at its own policy objectives. Therefore, as I mentioned earlier, although monetary policy has been tightened in a considerable number of countries, in terms of the Taylor rule the tightening is still insufficient. Countries that import resources tend to see a surge in resource prices as a supply shock. A rise in resource prices forces importers to pay more to obtain the same volume of resources, and thus results in an income transfer from importers to exporters. Therefore, unless the negative impact on importers is offset by an increase in exports to resource exporting countries, the rise in import prices exerts inflationary pressures as well as downward pressure on resource importers' economies. Countries will determine their monetary policy depending on the extent of such downward pressure and

other countermeasures taken by the government. Thus, upward risks to resource prices remain unless the tightening is sufficient on a global basis. And because the ratio of additional spending to additional income in resource exporting countries declines, the greater the price rise, the greater is the possibility of a larger economic downturn in the resource importing countries. In order to avoid such a situation, it is desirable that the world economy decelerates to a level that will induce resource prices to stabilize. However, this scenario of a soft landing is beset with many uncertainties.

In general, each country bases its monetary policy on its own objectives. However, given that the monetary policy of a large country affects the global economy in some form or other, it must carefully consider its policies by taking into account the possible repercussions on it of the changes in the global economy.

Furthermore, a surge in resource prices may cause current account deficits. At the time of the first oil crisis in autumn 1973, members of the Organization of the Petroleum Exporting Countries (OPEC) did not increase spending in proportion to the increase in their oil income, so that the increase in oil prices led to current account deficits in oil importing countries and the issue of how the oil money was to flow back to the deficit countries became a major problem. The Eurodollar market temporarily dried up, and Japan, with concerns over financing, had to conclude a confidential agreement with Saudi Arabia for the procurement of foreign exchange. In the present situation, exporters of resources up to now have been increasing expenditure and the rise in resource prices has not posed a serious threat to the external balances of importing countries. A further rise in resource prices, however, could increase the current account deficits of resource importers and create financing problems. This risk is more likely to materialize in countries with high inflation rates. While Japan is not among those countries,

there is still a possible risk that such problems would arise in other oil importing countries and that the effects would spread to Japan through financial markets.

B. Understanding the Causes of the Deterioration in the Terms of Trade

Moving on to the second point regarding the relationship between the terms of trade and monetary policy, it is important in the conduct of monetary policy to understand the factors behind the deterioration in the terms of trade. This is because the deterioration's effect on domestic prices depends on whether it stems from a rise in import prices or a fall in export prices. In practice, the terms of trade in Japan have deteriorated more sharply than those in other advanced countries, and this is due in part to movements in Japan's export prices. In the United States and Europe, export and import prices have historically moved in the same direction, while in Japan, except for the time of the oil crises, export prices, in sharp contrast with import prices, has remained stable and low (Chart 6). This owes to Japan's export structure, where electrical machinery and transportation equipment, prices of which tend to decline as a result of improved productivity, account for a large export share. Generally speaking, import prices tend to fall as a result of technological progress in the emerging economies, and the terms of trade gradually improve. In Japan, however, this trend has been offset by the effects of the export characteristics just described.

Another important point to consider is the changing global economic structure. The rise of emerging economies has changed the relative prices of resources and food on the one hand and all other items on the other. Relative prices are, so to speak, in the process of finding a new equilibrium. This is a reflection of the global trend in which demand for resources and food has been rising faster than for other products. This is because the share of emerging countries in global economic growth is increasing, which means that they are also accounting for a growing share of global demand. Moreover, as incomes in emerging economies

rise, the demand for energy increases due to the wider use of automobiles, air conditioners, and the like. Per capita oil consumption thus is likely to rise faster than per capita GDP. Consequently, an increase in the weight of emerging economies in global economic growth means that there is faster growth in the demand for resources even if the growth rate of the global economy remains unchanged. The new supply-demand balance resulting from this structural change raises the prices of resources and food around the world relative to other products. As Japan relies mostly on imports for resources and food, this structural change results in a deterioration in the terms of trade.

On the basis of the new supply-demand balance brought about by the significant structural changes in the global economy, labor productivity will decline as a result of the reduction in the use of resources whose prices have surged. This will lead to a decline in real wages and consequently to a fall in the potential growth rate. Since adjustments in prices other than those of resources and food as well as wages take time, it is likely that inflation and unemployment are likely to increase temporarily during the transition to the new equilibrium of relative prices based on the new supply-demand balance. In that case, a rise in inflation may lead to a rise in the rate of inflation expected by the public.

In relation to the conduct of monetary policy, it is difficult to determine the levels of new relative prices based on the new supply-demand balance brought about by the rise in the relative importance of emerging countries. Moreover, it is also difficult to clearly determine whether the rise in the inflation rate is part of the adjustment process to a new equilibrium of relative prices or whether it is the result of the synergistic increase in wages and the inflation rate, that is, a manifestation of the second-round effects mentioned earlier. The important point is that it is necessary to try to forestall such secondary effects in order to achieve sustainable economic growth under price stability. To this end, the

Bank will keep watch for any signs that add to inflation expectations while also keeping an eye on developments in inflation overseas.

C. A Surge in Resource Prices and the Unavoidable Burden on the Public

The third point regarding the relationship between the terms of trade and monetary policy I would like to make is that it is important to understand that when the terms of trade deteriorate due to a surge in resource prices, it is inevitable that this will impose a burden on the resource importing countries. Of course, how this burden is shared among importing countries, between large and small firms, and between households and firms, depends on such factors as the degree of energy efficiency, the pace at which the price rises are passed on, developments in exchange rates, the extent of wage restraints, and monetary policy. At present, although Japan's energy efficiency is high, it is workers and small firms that shoulder a large share of the burden because of the difficulties in passing on price rises and the tight restraint on wages mentioned earlier. Although, as I just explained, inflation and unemployment are likely to rise in the transition to a new equilibrium of relative prices, the Bank is determined to do its utmost, through its conduct of monetary policy, to smooth out the process of returning to a sustainable growth path under price stability. From the viewpoint of reducing the burden on the public, what is essential is investment in resource and energy conservation together with additional efforts to increase productivity.

Haruo Mayekawa, who was Governor of the Bank during the second oil crisis, made the following comment at a convention in May 1983 commemorating the 40th year of the Japan Society of Monetary Economics: "The general public also has come to understand that preventing the recurrence of inflation is a prerequisite for sustainable economic growth Needless to say, the Bank of Japan's top policy objective remains maintaining price stability. Inflation is an impediment to the market mechanism and not only has a downward spiraling

effect on economic efficiency, but also causes serious damage to the social fabric by distorting economic fairness and adding to social and political friction. The Bank will keep these points in mind and will not be led astray by the lure of growth and higher employment in the short term. The Bank will remain committed to achieving price stability, even if its dedication to this policy turns out to be unpopular for the time being." Although Japan's economy remains sluggish at present, I would like to reconfirm and share with the public the belief that keeping inflation under control is the precondition for achieving sustainable economic growth.