Summary of a Speech Given by Toshiro Muto, Deputy Governor of the Bank of Japan, at the Keizai Club in Tokyo on April 4, 2007

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Bank of Japan

Introduction

Today I would like to talk about the recent state of the economy and prices, as well as to explain the basic framework of, and thinking behind, the Bank of Japan's conduct of monetary policy, including the reasoning behind the policy adjustment at its Monetary Policy Meeting (MPM) in February.

I. The Economy and Prices: Current Situation and Outlook

A. Overseas Economic Developments

Let me start with the current state of overseas economies and their future outlook.

In the United States, the pace of economic growth has been decelerating, mainly reflecting adjustments in the housing market. So far, however, the influence of the adjustments in the housing market on the economy has been limited. Labor market conditions remain tight, with a marginal slowdown in employment gains. In this situation, the pace of deceleration in private consumption has been moderate, supported mainly by an increase in household income. Developments in the U.S. corporate sector are generally firm, since profits remain at high levels and business fixed investment, although decelerating somewhat, is maintaining its uptrend. With regard to housing finance, some people voice concern that the delinquency rate for mortgage loans to subprime borrowers (those with relatively low credit standing) has been rising recently, but the prevalent view is that this is unlikely to pose a threat to the overall economy or the financial market because the share of subprime loans in overall mortgage loans is not very large. Nevertheless, given that the likely extent of future adjustments in the housing market is still uncertain and the core consumer price index (CPI) continues to increase at a relatively rapid pace, attention should be paid to both the downside risk of a further economic slowdown and the upside risk of inflation. Taking all available data for the U.S. economy and prices into account, however, the economy is likely to realize a soft landing -- that is, after experiencing a moderate slowdown for a while it will move onto a path of stable growth, at a rate near its potential, as adjustments in spending in the household sector abate.

In the euro area, economic recovery continues to be solid, since the increase in production and improvement in corporate profits have led to recovery in business fixed investment and private consumption. In Germany, the value-added tax rate was increased in January this year. This precipitated some last-minute rises in the consumption of certain products, which subsequently fell back again, and since January has also pushed up consumer prices to some extent; however, it has not so far had a significant impact on either consumption or any other part of the economy. In China, both domestic and external demand continue to expand strongly, and the NIEs and ASEAN economies continue to expand at a moderate pace on the whole.

Taking these developments into account, overseas economies as a whole are likely to continue to expand, with some possible slowdown in the U.S. economy offset by expansion elsewhere.

With the plunge in the Shanghai stock market at the end of February, stock prices worldwide declined substantially. In corporate bond markets in the United States and Europe, for example, there was some reassessment of credit risk, as seen in wider credit spreads between government bonds and corporate bonds, especially those with low credit ratings. In foreign exchange markets, the yen appreciated against the U.S. dollar. In May-June 2006, there was a worldwide adjustment in financial markets, the so-called "global risk reduction," but this was followed by an upturn in stock prices, a narrowing of credit spreads on corporate bonds, and a depreciation of the yen, all of which lasted up until the end of February. The most recent adjustments can be considered as an unwinding of investments made during this period. Global investors' stance toward risk-taking may have become more assertive in the wake of their success in dealing with the global risk reduction as well as the relatively modest volatility in financial markets seen subsequently. This more assertive risk-taking behavior seems to have been modified in response to the plunge in Chinese stock prices and the release of some weak data on the U.S. economy. As I have mentioned, there has been no significant change in the fundamentals of the global economy, but we will continue to pay close attention to developments in financial markets and any possible implications for economic activity.

B. Economic Developments in Japan

Against the background of the strong growth in overseas economies, Japan's economy has been experiencing a sustained period of moderate expansion. The current economic expansion, which started in January 2002, is now in its sixth year.

1. Developments in the corporate sector

Reflecting the expansion of overseas economies, Japan's exports are likely to continue to increase. Business fixed investment is also expected to keep increasing on the back of strong corporate profits and steady demand at home and abroad. This favorable situation in the corporate sector is confirmed by the latest March *Tankan* (Short-Term Economic Survey of Enterprises in Japan). Survey results in the March *Tankan* suggest that firms as a whole have made upward revisions to their projections for current profits for fiscal 2006 from the forecasts reported in the December *Tankan.* They are expecting profits for fiscal 2006 to have increased by 6.2 percent from the preceding fiscal year, posting a fifth consecutive year-on-year increase. Ratios of current profits to sales exceeded the levels posted during the period of the bubble economy. The results for business fixed investment suggest that firms on aggregate are expecting their capital investment for fiscal 2006 to have grown by 9.5 percent from a year earlier, its fourth consecutive year of growth. Business fixed investment planned for fiscal 2007 is also at a relatively high level for the time of year, namely, the turning point in the fiscal calendar. It seems, however, that firms, seeking to boost production capacity so as not to miss the opportunity to increase profits in the global market, are maintaining their cautious scrutiny regarding the profitability of individual investment projects, having become more exposed to the discipline of the capital market.

Against this background of growth in domestic and external demand, production is on an upward trend. Although production has been decreasing somewhat since January, this is largely due to a downward reaction to the high growth posted in the October-December quarter of 2006 as a result of increased automobile production. On average, production has been increasing by around 1 percent quarter on quarter. Inventories have been more or less in balance with shipments in the industrial sector as a whole, but inventories of electronic parts and devices have been at elevated levels since the second half of 2006 due mainly to accelerated production leading up to new product releases. Although strong demand for IT-related goods is likely to prevent sharp adjustments in inventories, attention should continue to be paid to developments in inventories of IT-related products as the pace of increase in global production capacity in this sector is rapid.

These positive developments in the corporate sector are reflected in firms' view of business conditions. Although the diffusion index for business conditions in the March *Tankan* registered a slight decline relative to the previous *Tankan*, on the whole it is still at a favorable level considering the adjustments that have been occurring in the financial market.

2. Developments in the household sector

The positive influence of the strength in the corporate sector has been feeding through into the household sector at a moderate pace. The number of employees continues to increase steadily. A closer look reveals that not only the number of part-time workers but also that of full-time employees is rising. A survey conducted by a private institute earlier this year indicated that more new graduates would be hired by firms in fiscal 2007 than in the previous year.

Despite the strength in the corporate sector, however, it is often said that households are not getting a real sense that the economy is expanding, and this seems to be related to the wage situation. To be more specific, the increase in nominal wages per worker, which had been only moderate, has recently appeared to stagnate. Regular payments are particularly weak, remaining somewhat beneath the level recorded last year. The sluggish growth in wages despite continued high corporate profits seems attributable to persistent labor cost restraint by firms, which feel the need to be more profit-conscious amid intensifying global competition and greater exposure to the discipline of the capital market. Moreover, employees' preference for stable employment over a wage increase after their past experiences of a severe employment situation, as well as the retirement of baby-boomers whose wage levels are relatively high, are also thought to share responsibility for the recent weak growth in nominal wages per worker.

Meanwhile, firms are increasingly feeling shortages of labor as shown in the March *Tankan*. If the number of employees keeps increasing while growth in the population of those aged 15 and over peaks out, upward pressure on wages should be expected to increase over time. Although the focus of attention tends to be the weak growth in regular payments, the positive influence of the strength in the corporate sector should not be overlooked, as this is now feeding into the household sector via various channels, such as increases in the number of employees, the wages of part-time and temporary workers, and dividends.

Although the pace at which the positive influence of the corporate sector has been filtering through into the household sector has been somewhat subdued, the gradual increase in household income is expected to continue, supported, for example, by growth in the number of employees on the back of continued high corporate profits.

With household income increasing gradually, private consumption has been firm recently. In summer 2006, private consumption declined temporarily due to unfavorable weather conditions and consumers' reluctance to buy before the introduction of new products; then from the autumn onward, sales at department stores and supermarkets were weak, weighed down by sluggish sales of winter apparel due to the unseasonably warm weather. However, sales data released since the turn of the year have been favorable, and sales of spring apparel seem to be strong. Sales of electrical appliances are showing clearer upward momentum recently, with sales of digital appliances such as flat-panel TVs and new game consoles growing steadily. As for services consumption, sales in the food service industry and outlays for travel have generally been firm. Looking forward, although unlikely to post substantial gains, private consumption is expected to be on a gradual uptrend, reflecting increases in household income.

In sum, in fiscal 2007 Japan's economy is likely to continue to experience a sustained period of growth at a pace slightly higher than its potential, with the virtuous circle of production, income, and spending remaining intact. If this turns out to be the case, our economy will have been growing at around 2 percent per annum since fiscal 2003. Such a sustained period of growth at a rate above the economy's potential, even though it coincides with a period of fiscal consolidation, is due to the strong expansion of overseas economies and the accommodative financial environment.

3. Developments in prices

I would now like to talk about the price situation. Recent price developments in Japan have been considerably influenced by past falls in the prices of crude oil and other international commodities. Crude oil prices have been experiencing declines since August last year, dropping sharply at the start of this year due to the unseasonably warm winter in the United States. Since then, however, they have bounced back somewhat, reflecting factors such as a cold spell in North America, the U.S. policy decision to increase its strategic petroleum reserve, and geopolitical risks, thus displaying some considerable fluctuation. Prices of nonferrous metals, meanwhile, declined up to and during early 2007 within elevated levels, with the decline most notable in copper. Recently, however, they have started to bounce back.

Reflecting the fall in international commodity prices, domestic corporate goods prices have been somewhat weak recently. In the short run, they are expected to be somewhat weak or flat, again due to the fall in international commodity prices.

As for consumer prices, the year-on-year rate of increase in the CPI (excluding fresh food, on a nationwide basis) has been decelerating since autumn 2006, and the most recent data indicated that in February the CPI declined by 0.1 percent from a year earlier, posting negative growth for the first time since April 2006. The sluggishness is largely attributed to developments in the prices of petroleum products, such as gasoline, which have recently declined from their levels the previous year, following a period of deceleration. In addition to this, the introduction of new billing plans for cellular phones has also been placing downward pressure on the CPI recently.

Judging from the basic environment surrounding prices, however, greater upward pressure on prices is expected. According to survey results reported in the March *Tankan*, the share of firms experiencing a shortage of production capacity exceeds the share of those feeling excess, and corporate managers are increasingly feeling shortages of labor. In this situation, resource utilization rates are rising steadily, and estimates of the output gap continue to be positive. Furthermore, downward pressure on prices from unit labor costs (labor costs per unit of output) is expected to weaken as the upward trend in wages becomes more distinct. In view of these developments in the underlying price environment, the CPI is expected, in the longer run, to trend upward. Nevertheless, it should be borne in mind that there are also downside risks, which could, if they materialize, make it harder for prices to swiftly regain an upward trend: an example is the progress of economic globalization, which may cause prices to respond less sensitively to changes in the output gap than hitherto, and cause wages to take longer to establish their recovery than projected.

II. Conduct of Monetary Policy

A. Framework for the Conduct of Monetary Policy

On the basis of this outlook for the economy and prices, the Bank decided on a policy adjustment at its MPM in February. The policy adjustment was decided in line with the framework for the conduct of monetary policy introduced in March 2006 and was the second such adjustment based on this framework, the first being the decision to bring to an end the zero interest rate environment in July 2006. Let me explain the outline of the framework before elaborating on the background for the policy adjustment in February.

The framework was introduced in March 2006 at the time the Bank terminated the quantitative easing policy and reinstated a policy of interest rate control. It consists of three elements. The first is to clarify what constitutes "price stability"; the second, to employ two perspectives for assessing the economic and price situation; and the third, to outline the Bank's thinking on the future conduct of monetary policy.

Let me explain each element in turn. With respect to "price stability," the stated objective of monetary policy, the Bank interprets this to mean "a state where various economic agents such as households and firms may make decisions regarding such economic activities as consumption and investment without being concerned about the fluctuations in the general price level." Furthermore, we have disclosed the amount of inflation that members of the Policy Board understand, when conducting monetary policy, as being consistent with price stability over the medium to long term. This is released as the members' "understanding of medium- to long-term price stability." Expressed in terms of the rate of year-on-year change in the CPI, this "understanding" takes the form of a range, between around 0 and 2 percent, with most members' median figures falling on one side or the other of 1 percent. It is this understanding of price stability that members have in mind when making monetary policy decisions. The "understanding of medium- to long-term price stability" could change gradually in response to structural changes in the economy, such as progress in economic globalization and in information and communication technology. Therefore, the Bank will, in principle, review it annually.

The second element is the employment of two clearly defined perspectives for assessing economic activity and prices when making policy decisions. From the first perspective, we will examine the prospects for economic activity and prices for one to two years ahead, assessing whether the most likely outlook is for the economy to follow a path of sustainable growth under price stability. Note that the focus is on the outlook. This is because it takes considerable time for monetary policy actions to filter through into the economy and prices. It is necessary, therefore, to conduct monetary policy in a forward-looking manner, taking into account expected economic and price developments. The key to achieving this is to establish what is the most likely outlook. The Bank thus produces a forecast for the economy and prices for about one and a half to two years ahead and publishes it in the April and October issue of its *Outlook for Economic Activity and Prices* (hereafter the Outlook Report). Also at each MPM, we look to update our picture of the most likely outlook by carefully analyzing incoming data and other fresh information. In this sense, the careful analysis of incoming data, in other words, being data dependent, does not contradict the idea of forward-looking monetary policy; rather, it constitutes a necessary ingredient.

Although we take the utmost pains when performing our analysis, any forecast entails a degree of uncertainty. In conducting monetary policy, it is necessary to consider the possibility that our most likely outlook for the economy and prices will not in fact materialize and to calculate the costs that this would entail, as well as to examine risk factors that may influence the economy and prices in the medium to long term, in other words, outside of the projection period. The second perspective, therefore, involves examining, over a longer horizon, the various risks that are most relevant to conducting monetary policy aimed at realizing sustainable growth under price stability. Since the second perspective looks at areas that are not covered in the first perspective, the two perspectives are complementary in nature. Moreover, our assessments are always based on both perspectives. Note, therefore, that it is not the case that policy decisions are based or rely heavily on one or the other of the two perspectives, depending on the circumstances.

The third element is to outline, based on the above assessments, the Bank's thinking on the future conduct of monetary policy and to publish this in the Outlook Report.

B. The Policy Adjustment in February

At the February MPM, the decision to raise the policy interest rate was taken after reviewing the economy and prices and assessing them from our two complementary perspectives, as I have described.

First, considering the prospects for the Japanese economy from the first perspective, we carefully analyzed various economic data released since the January MPM in addition to all relevant information available prior to it. On the basis of this careful analysis and discussion at the MPM, we came to the conclusion that the economy was likely to continue to experience a moderate expansion with a virtuous circle of production, income, and spending in place. As referred to earlier, the world economy continues to expand, with growth more balanced as regional economies gain momentum. Indeed, this was the consensus view among delegates at the G-7 meeting in February. Domestically, newly available figures for the fourth quarter of 2006 indicated that business fixed investment was increasing on the back of high corporate profits. The sluggishness in private consumption seen last summer was judged a merely temporary phenomenon, and a gradual increasing trend was reaffirmed. Meanwhile on the price front, it was considered that the year-on-year rate of change in the CPI (excluding fresh food) might register around zero in the short run, depending, for example, on developments in the prices of crude oil. However, in the longer run, the CPI was judged likely to trend upward given increased resource utilization and the expected continuation of economic expansion. In other words, taking a forward-looking perspective on the economic and price situation for one to two years ahead, prices were judged likely to trend upward given the fundamentals behind the economy and prices, even if the rate of change in the CPI might temporarily fall into negative territory in the short run. Considering this forecast for the economy and prices in the light of the Bank's "understanding of medium- to long-term price stability" referred to earlier, it was likely that sustainable growth under price stability would be achieved.

This outlook is based on the assumption that private economic agents such as market participants and firms make decisions on economic activity by factoring in, to some extent, future policy changes. Thus, with prospects for the economy and prices improving, gradually adjusting the level of the policy interest rate as these anticipated improvements come to pass will facilitate the smooth realization of the outlook's favorable predictions and lead in turn to a long-lasting economic expansion.

Second, turning to the longer horizon of the second perspective and examining the various risks most relevant in conducting monetary policy, it appeared likely that, with the prospects for the economy and prices improving, the stimulative effects of monetary policy would increase if the policy interest rate were left at its recent level. If the expectation were to take hold, in such a situation, that interest rates would remain low for a long time regardless of developments in economic activity and prices, then economic agents such as financial institutions and firms would behave accordingly. The result could well be a misallocation of resources in the long run as agents became over-extended in financial markets or poured funds and other resources into inefficient economic activities. This could then interfere with the sustained economic expansion. In the October Outlook Report, this was deemed one of the risk factors whose materialization, although not necessarily probable, would involve sufficient economic costs that it should be considered a "relevant" risk in conducting monetary policy. I must emphasize, however, that this risk factor involves a putative future scenario; it does not describe a situation that has already emerged.

Picking up on the Bank's concern with this risk factor, some market participants have seen the recent policy action as an attempt to exert direct influence on the foreign exchange rate and yen carry trade. However, considering the substance of the Bank's thinking, as I have explained it earlier, makes it clear that this is not the case. Monetary policy is conducted with the aim of steering the Japanese economy toward sustainable growth under price stability, and careful examination of the economy and prices is carried out with this aim in mind. The Bank's basic view is that developments in financial markets, including the foreign exchange market, are factors that may influence economic activity and prices and it is in this capacity that they come to the attention of monetary policy.

At the February MPM, the Bank judged that for the economy and prices to follow a desirable path, we had reached an appropriate juncture to adjust the level of the interest rate. The operating target of the policy interest rate (the uncollateralized overnight call rate) was therefore raised from around 0.25 percent to around 0.5 percent.

At the same time, the basic loan rate applicable under the complementary lending facility was raised from 0.4 percent to 0.75 percent, widening the interest rate differential between the basic loan rate and the operating target of the uncollateralized overnight call rate from 0.15 percent to 0.25 percent. The interest rate under the complementary lending facility serves as an upper limit on the overnight call rate. When the interest rate differential between the interest rate under the complementary lending facility and the operating target of the call rate is small, the call rate tends to diverge less from its target, but the free formation of market interest rates is restricted. In view of the stability of the call rate since the zero interest rate environment was brought to an end in July last year as well as the gradual recovery in the functioning of the money market, it was judged that some widening of the interest rate differential will not hamper smooth interest rate control.

C. The Conduct of Monetary Policy in the Near Future

With regard to the future course of monetary policy, the Bank intends, as previously stated, to "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." Actual policy actions will be decided through careful analysis of the prospects for the economy and prices, and thorough discussion among Policy Board members at each MPM. As we have repeatedly stated, we do not have a predetermined schedule regarding the future policy actions.

We have often been asked by market participants and the press whether this process of gradual interest rate adjustment should be regarded as "normalization." The term "normalization," however, carries various meanings. If the term "normalization" is being used to imply that interest rates are adjusted toward a particular so-called "neutral" level in line with a predetermined schedule, then we should make clear that we have no such intention. The Bank's approach to the conduct of monetary policy, as I have previously stated, is to keep accommodative financial conditions ensuing from very low interest rates for some time, and to adjust the level of interest rates gradually in the light of developments in economic activity and prices. The views of all members are entirely consistent on this point. Therefore, adjustments in the level of interest rates will be carried out in the light of developments in economic activity and prices, and not in line with any predetermined schedule. If the term "normalization" can be used to describe such a process, then perhaps it would be fair enough to say that we will be adjusting the level of interest rates gradually in light of the "normalization" of economic activity and prices. In any event, we think the least misleading option is for our basic thinking stated in the Outlook Report and in the press release accompanying the February policy action to be read exactly as stated.

D. Communicating with the Market

In connection with the February policy change, there is criticism that there may have been some confusion in the process of communicating with the market since the end of last year when the policy action began to be the target of speculation. We accept such criticism and will try to improve the means of communication in the future.

It may be productive, at this point, to summarize our approach to communication between the central bank and markets. Since monetary policy takes effect through financial markets and the behavior of financial institutions, ensuring its transparency is important not only in terms of accountability to the general public but also to improve the policy's effectiveness.

Monetary policy needs to be transparent both with regard to the policy content and with regard to the means of conveying this content to the public. In terms of the latter, the Bank has employed various communicative media, such as the Outlook Report, the *Monthly Report of Recent Economic and Financial Developments*, the minutes of the MPMs, and press conferences, all of which can be easily accessed by the general public. As far as the contents of the policy itself are concerned, we believe there are two key pieces of information that the central bank needs to provide: the central bank's assessment of the economic and price situation; and its basic thinking on the conduct of monetary policy. Market participants can form expectations regarding future interest rates by adjusting their views of the economy and prices on the basis of such information, while central banks can deduce market participants' views regarding the economy and prices from market interest rates and yield curves. What we have in mind in terms of communicating with the market is such a two-way exchange of information.

Hinting at the actual timing of the policy change is generally inadvisable. If such a hint were made, market participants would carry out transactions based not on their own views of the economy and prices but in response to the Bank's hint, and this would result in a breakdown of the two-way exchange of information. Furthermore, at many central banks, including the Bank of Japan, policy decisions are made after thorough discussion among members of the policy meeting, culminating in a vote. In the absence of such discussion, to indicate whether or not a policy change will take place or to set a particular schedule for policy changes is inconceivable.

Based on such an understanding of communication between the central bank and the markets, the Bank will stick closely to its principle of carefully explaining to the public its assessment of the economy and prices, and its basic thinking regarding the conduct of monetary policy. Meanwhile, to further facilitate meaningful communication with the market, we trust that the Bank's understanding in this regard will be widely recognized by market participants.

Concluding Remarks

I have discussed the outlook for economic activity and prices, and our basic thinking on the conduct of monetary policy along with some issues related to communication with the market.

The Bank will publish a new Outlook Report later this month in which our projections for the economy and prices up to fiscal 2008 will be released. In addition, the "understanding of medium- to long-term price stability" will come up for its first annual reexamination since the introduction of the "New Framework for the Conduct of Monetary Policy."

The Bank will take advantage of such opportunities to further refine this framework and will continue to contribute to the achievement of sustainable economic growth under price stability through the appropriate conduct of monetary policy.