July 24, 2008

Bank of Japan

The Increasingly Complex Economic and Financial Climate and Policy Responses

Excerpts of a Speech at a Meeting with Business Leaders in Aomori

Atsushi Mizuno

Member of the Policy Board

I. Growing Global Inflationary Pressures

A. Global Inflation and Its Background

Inflation rates have been rising worldwide due to the surge in prices of natural resources and energy as well as crops. The year-on-year rates of increase in the headline consumer price index (CPI) in major economies have been climbing steadily, as seen in the readings for Japan for May 2008 and the United States and the euro zone for June 2008, which came in at 1.3 percent, 5.0 percent, and 4.0 percent, respectively. Given that prices of petroleum products and food are still rising, the headline CPI inflation rates may reach 5.5 percent in the United States, 4.5 percent in the euro zone and the United Kingdom, and 2.5 percent in Japan within the next few months.

At the same time, inflation rates have also been rising significantly in emerging economies, reaching 15.1 percent in Russia, 7.1 percent in China, 5.5 percent in South Korea, 8.9 percent in Thailand, 11.4 percent in the Philippines, and 26.8 percent in Vietnam. The number of economies with double-digit inflation rates is expected to increase further.

Looking at the share of food items in the CPI of individual countries, this is generally small in advanced economies such as the United States (9.8 percent), the euro zone (15.6 percent), Japan (19.7 percent), and the United Kingdom (11.8 percent). On the other hand, the share is relatively large in emerging economies such as China (34.4 percent), India (51.4 percent), the Philippines (46.6 percent), Thailand (36.1 percent), Turkey (32.0 percent), and Brazil (21.0 percent). These shares illustrate why the surge in food prices is one of the major reasons for the increase in the CPI. As an aside, it should also be noted that the surge in food prices may lead to political problems. Asian economies in particular are sensitive to price rises in crops as they depend heavily on rice, the price of which has recently surged dramatically. In other words, there are concerns that food shortages may lead to political problems and an increase in geopolitical risks, such as strengthened protectionism and social unrest.

Reasons for the current surge in prices of natural resources and energy as well as crops include financial factors such as the inflow of funds from pension funds into these markets as well as speculative activity, supply constraints such as those due to insufficient investment in oil drilling and refining capacity, and geopolitical factors. Personally, however, I think the primary cause is demand factors, that is, demand stemming from the favorable conditions in emerging economies. The ascent of economies that inefficiently consume massive amounts of energy, such as China and India, and the strength of real demand from emerging economies mainly due to the effects of U.S. monetary easing are at the bottom of the inflation in natural resource and crop prices. I do not believe that the surge in prices of natural resources and crops is attributable only to an economic bubble or speculation.

The reasons why I think that demand factors are the primary cause of the price surge are as follows. First, although the pace of growth in emerging economies is slowing and the output gap is narrowing, the extent of the slowdown is insufficient to restrain inflationary pressures and demand for natural resources and crops therefore is unlikely to weaken much. In the *World Economic Outlook Update* released by the International Monetary Fund (IMF) in July, projected real GDP growth rates for Asian economies for 2008 and 2009 are 9.7 percent and 9.8 percent for China, 8.0 percent and 8.0 percent for India, 4.2 percent and 4.3 percent for the NIEs, and 5.6 percent and 5.9 percent for the ASEAN-5. Second, inventory levels have been extremely low on the whole, despite the rise in commodity prices. Third, prices of agricultural products, which are not suitable for serving as a store of value, have been rising as well. And fourth, prices of iron ore, which is not traded in the futures markets and whose prices thus are not affected by financial activities, have also been rising.

I believe that the increase in inflationary pressures in some emerging economies partly reflects the substantial monetary easing by the U.S. Federal Reserve. Since last year, the Federal Reserve has taken drastic monetary easing measures, but their direct stimulative effects on the U.S. economy have been limited so far due partly to the tightening of U.S. banks' lending attitudes. Meanwhile, the monetary easing in the United States has delayed monetary tightening in those emerging economies that have pegged, or de facto linked, their currencies to the U.S. dollar, such as the oil-producing countries in the Middle East and some East Asian economies. As a result, growth in emerging economies has remained steady, but at the same time, inflation has picked up since the beginning of this year.

In China, India, and many other East Asian economies, sharp increases in resource and crop prices have been largely offset by government subsidies. However, because the fiscal balance of these economies has deteriorated rapidly as a result of the recent surge in energy prices, governments are no longer able to provide subsidies on the same scale and thus retail prices have started rising.

There is also concern in emerging economies regarding the risk that the surge in prices of resources and crops may lead to second-round effects, since the rates of increase in wages are generally high in these economies. On the other hand, although the prices of petroleum products and food in advanced economies are rising sharply, there has been no notable acceleration in the rate of increase of the prices of other consumer goods. In other words, there has been a change in the relative prices between petroleum products and food on the one hand and other consumer goods on the other, and it is this structural change in relative prices that characterizes the current inflation in the advanced economies.

B. Central Banks' Policy Response

Regarding the price outlook, the upward pressure on prices of natural resources and energy as well as crops is likely to continue. According to the *World Economic Outlook Update* released by the IMF in July, the year-on-year rate of increase in consumer prices for the years 2008 and 2009 -- at 9.1 percent and 7.4 percent respectively for emerging and developing economies, and 3.4 percent and 2.3 percent for advanced economies -- is forecast to remain high, particularly for emerging and developing economies. A senior staff member of the IMF recently expressed the view that "inflation risks have reemerged as a global challenge following a long absence." He was also of the opinion that the "inflation speed-up must be taken seriously, as it creates potentially significant challenges to economic stability," and that the possibility of a return of "rising inflation expectations and sustained inflation pressures" similar to the early 1970s "cannot be discarded out of hand."

Looking back at the past decade, a major theme for policymakers in all countries, when considering the outlook for their economies as well as the world economy, was how to assess the effects of economic globalization. Various types of "borderless" business have become commonplace in a wide range of sectors, including international trade, finance, transportation, and telecommunications. At the same time, countries with large populations such as China, India, and Russia have been incorporated into the global economic system, while the economic strength of natural resource-exporting countries such as the oil-producing countries in the Middle East, Brazil, and Australia has grown due to the surge in the prices of natural resources and crops. As a result, the political relations between advanced economies and these countries also have gained increased significance. As a central banker, I think that, given excessive global demand, interest rate levels worldwide are too low. The central banking community continues to discuss how monetary policy should be conducted in response to the global price shocks that all countries face in common.

Suppose, for example, that the main cause of the surge in resource and crop prices is the increase in demand in emerging economies. In this case, the best solution would be for policymakers in these economies to take the initiative in solving the problem. Specifically, it is important that they make efforts toward curbing the overheating of their economies through monetary tightening, cutting fuel subsidies to reduce crude oil consumption, and improving the efficiency of energy use.

In this situation, monetary authorities in Asia are moving toward a tightening of monetary policy to contain rising inflation, although the measures to do so differ from country to country. They include, for example, steps to shore up the domestic currency, increases in policy interest rates, and macroeconomic controls such as window guidance. In practice, however, emerging economies are likely to tighten monetary policy in stages to avoid an excessive slowdown in growth, and it is likely to take some time until monetary conditions in these economies are tightened sufficiently and global demand for energy and crops weakens.

The central banks of major economies have been seeking to curtail global demand for crude oil at the expense of domestic growth. However, there is limited room for these central banks to take measures to reduce inflationary pressures arising from external factors such as the rise in prices of crude oil and food, as long as the overheating of emerging economies continues. This is especially true for countries like the United States, where a negative feedback loop has formed between causal factors -- plunges in home prices and concerns about financial system stability -- and resulting concerns about downside risks to the economy. The S&P financial index has recently dropped to levels last seen in 2002 due to concerns about a deterioration in the business conditions of a major investment bank and of Fannie Mae and Freddie Mac. This situation poses a difficult challenge for the Federal Reserve, although it may not need to take measures immediately since the inflation rate in terms of the CPI for all items less energy and food, or the core CPI, is unlikely to rise further for the time being.

Central banks in the various countries or regions are likely to conduct the monetary policy they consider the most appropriate, while maintaining a balance between downside risks to economic growth due to the deterioration in the terms of trade and upside risks to inflation expectations.

In a column published in the Financial Times on June 25, 2008, "How to manage the world economy through two crises," the columnist Martin Wolf provides interesting thoughts on what measures policymakers around the world should take.

Mr. Wolf notes, "Two storms are buffeting the world economy: an inflationary commodity-price storm and a deflationary financial one," and that "the place to start is with the world economy as a unit. The more globalised economies become, the more appropriate it is to think of the world economy in this way. So what have we learnt about the world economy as a whole?" His answer is that the world economy "is running into limits on resources, at least in the short term," and this seems to be the cause of the surge in resource prices, which has generated inflationary concerns globally.

Mr. Wolf further says: "Yet will this decline in the rate of growth in the high-income countries cool an overheated world economy sufficiently? Perhaps not. The OECD expects a decline in growth outside the OECD, but to levels still above . . . potential." The World Bank also expects that growth in developing countries will decelerate, but only slowly. Mr. Wolf continues: "Against this difficult background, what are the right responses and how should they be distributed, across the globe? These need to be divided into the short term and the longer term. In the short term, the biggest monetary policy requirement is a tightening in emerging economies . . . Monetary tightening is less obviously necessary in high-income countries." He emphasizes the importance of cuts in fuel subsidies and of "letting the jumps in energy prices pass through, so forcing the needed adjustments in energy use," and notes that in the medium to long term, "the biggest priority is to release energy constraints on growth. This means increased public and private investment in energy research, particularly in renewables." Mr. Wolf concludes: "Ideally, countries would act together. But whether they act together or not, they must act. Otherwise, greater danger -- even a bad dose of stagflation -- lies ahead."

Personally, I think that in order to stabilize the world economy, a stabilization in crude oil prices is essential. This would require a concerted effort that would include (1) encouraging oil-consuming countries to use part of their strategic petroleum reserves, (2) encouraging oil-producing countries to increase oil production, and (3) a reduction in investments in commodities by pension funds. In other words, I think there is a limit to what monetary policy alone can do to reduce inflationary pressures worldwide.

In emerging markets, which are caught between the dilemma of increasing inflationary pressures and hightened concerns about an economic slowdown, developments in stock prices and currencies have been volatile due to increased uncertainty regarding the outlook for monetary policy and long-term interest rates. Particularly the increasing inflationary pressures in the East Asian economies warrant close monitoring since they are becoming a new "fog" surrounding Japan's economy.

II. Thoughts on the Conduct of Monetary Policy

A. Points to Be Considered with Regard to Monetary Policy

In Japan, the deterioration in the terms of trade resulting from the surge in energy and materials prices has posed a high risk of a worsening of domestic private demand. Looking specifically at the terms of trade, which are calculated by dividing the export price index by the import price index and multiplying the result by 100, the rate of change from a year earlier was -14.5 percent in April, -14.8 percent in May, and even -18.2 percent in June.

In general, monetary policy cannot contain inflationary pressures related to a change in relative prices such as those brought about by the surge in energy and materials prices. However, in the case of second-round effects -- where the surge in energy and materials prices further increases wages and prices through the heightening of inflation expectations of firms and households -- monetary tightening becomes necessary to put a brake on these effects. In Japan, such effects have not occurred so far, as evidenced by the fact that growth in wages remains stable at an annual rate of around 1 percent.

Turning to the assessment of Japan's economy, the June 2008 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) and reports at the meeting of general managers of the Bank of Japan's branches clearly indicated a slowdown in the economy. Looking at the Indexes of Business Conditions, especially the coincident composite index (CI), it seems highly likely that the government will soon revise downward its assessment of the economy from possibly being at a turning point to deteriorating. In terms of the reference dates of business cycles, the most recent economic expansion, which began in January 2002, may be found to have peaked in the October-December quarter of 2007 and to have entered a mild recession thereafter. A cause of concern in this situation is a possible fall in household spending due to a decrease in households' real purchasing power. It now looks very likely that private consumption on a GDP basis in the April-June quarter will turn out to have registered a negative rate of change from the previous quarter. Nevertheless, the economy seems resilient, because firms currently face no excess in inventory, production capacity, or employment. This means that even if the economy were to be hit by external shocks, a large-scale adjustment is unlikely to occur. Moreover, despite the economic slowdown in the United States and Europe, the global economy is likely to continue to expand, albeit at a slower pace, as emerging economies and natural resource-exporting countries continue to show strong economic growth. Therefore, on balance, the environment for Japan's exports is likely to remain somewhat favorable.

I believe, therefore, that what the Bank should do in the current situation is to closely monitor, without having any predetermined view, downside risks to domestic private demand and upside risks to inflation -- both of which reflect the high energy and materials prices -- and also developments in global financial markets.

Market participants' attention has mostly been focused on developments in global financial markets and the U.S. economy, but I am more concerned about economic and price developments in emerging economies. Specifically, I am concerned about whether these economies can take appropriate macroeconomic policy steps to contain inflationary pressures or whether, alternatively, as a result of insufficient monetary tightening, accelerating inflation in these economies leads to a reduction in real income and a greater-than-expected economic slowdown, which then could lead to a greater-than-expected decline in Japan's exports from the second half of fiscal 2008 through fiscal 2009. If emerging economies, particularly those in East Asia, experience a deceleration, a downward revision of the outlook for Japan's economy will be inevitable.

If energy prices remain at their unprecedented high levels, a considerable amount of income will be transferred from importers to exporters of natural resources. One interpretation of this situation is that it is no longer appropriate to classify economies worldwide only into two groups, advanced economies on one hand and emerging economies consisting of newly industrialized countries and developing countries on the other. This is because emerging economies themselves have recently fallen into two groups: a group of economies that face a relatively high risk of economic deceleration because of the slowdown in the U.S. economy, the surge in international commodity prices, and the tightening of monetary policy to contain inflationary pressures; and a group of natural resource-exporting countries whose domestic demand remains robust due to the improvement in their terms of trade resulting from the surge in resource prices, and whose high year-on-year CPI inflation caused by the surge in crude oil prices is offset to some degree by subsidies. The former includes economies in East Asia, while the latter includes the oil-producing countries in the Middle East.

The income transfer from Japan to natural resource-exporting countries as reflected in the deterioration in the terms of trade has depressed corporate profits and households' real purchasing power in Japan, thereby increasing downside risks to Japan's domestic private demand. Meanwhile, other East Asian economies, most of which also rely on imports of natural resources, are showing signs of an economic slowdown. In these economies, the acceleration of inflation has become a serious social problem, and an increasing number of these economies are tightening monetary policy to reduce inflationary pressures, even though this will to some extent hurt economic growth. If the sharp rise in the prices of resources and crops were to come to a halt as a result of a slowdown in emerging economies, the downside risks to Japan's domestic private demand would decrease somewhat. However, close attention is warranted, since at the same time, Japan's exports to East Asian economies and oil-exporting countries in the Middle East are highly likely to decelerate.

As to risks surrounding the outlook for the world economy, upside risks to inflation and downside risks to economic growth are finely balanced, since the acceleration of inflation has been offset by concerns over financial system stability and by the risk of a slowdown in world economic growth. If this balance were to come unstuck, this would increase the risk of significant changes in government bond yields in major economies and of a further decline in stock prices. The direction of monetary policy in principle should be determined on the basis of the medium- to long-term outlook for the domestic output gap, but the high volatility in financial markets and the increase in global inflationary pressures also need to be taken into account as these factors heighten the downside economic risks for all the major economies.

In June, volatility in global bond markets became high as the Federal Reserve and the European Central Bank (ECB) clearly indicated their intention to combat inflation, although the two differed in the degree to which they considered monetary tightening to be necessary.

I personally thought at the time that, with a view to minimizing negative spillover effects from the volatile U.S. and European financial markets to Japan, it was important for the Bank to reiterate the following points: first, the situation required the Bank to be cautious about both downside risks to the economy and upside risks to inflation; and second, the monetary policy stance of major central banks should differ. In fact, it is only natural that there are differences between the policy stance in Japan -- where, as a result of the deterioration in the terms of trade due to inflation in the prices of resources and crops, risks have already materialized in the form of decreased corporate profits and sluggish demand -- and that in other major economies, where concerns focus on the risk that the rise in materials costs may lead to an increase in wages and higher inflation expectations.

The "fog" surrounding Japan's economy stems from (1) the turmoil in the U.S. and European credit and stock markets due to the U.S. subprime mortgage problem and (2) downward pressure on domestic private demand reflecting high energy and materials prices. In addition to these two factors, which the Bank has noted, I personally think there is a new "fog" developing of rising inflationary pressures in emerging economies in East Asia.

I think that the "fog" surrounding the Japanese economy is unlikely to clear any time soon. At this juncture, from the viewpoint of achieving the Bank's policy objective of contributing to sustainable growth with price stability, I believe that the best course of action for the Bank is to keep its policy unchanged. Since March 2007, the Bank has not changed the guideline for money market operations and has also maintained the assessment that financial conditions are generally accommodative. In the public statement released after the Monetary Policy Meeting (MPM) on July 15, the Bank explained that if the downside risks to the economy were to decrease, there would be an increased risk that prolonging the period of accommodative financial conditions would lead to swings in economic activity and prices. Thus, I would like you to be aware that the Bank is acutely alert to the risk that the continuation of the key interest rate at 0.5 percent may pose adverse side effects given the level of Japan's potential growth rate, and thus at each and every MPM discusses the most appropriate monetary policy conduct.

B. On Further Enhancing Communication Regarding the Conduct of Monetary Policy

Lastly, I would like to express my view regarding the Bank's strategy for communication regarding the conduct of monetary policy. Given that global economic and financial conditions are constantly changing, the times require that the Bank explain in a timely and thorough manner its assessment of current economic and price conditions and their future course as well as attendant risk factors.

The Bank released "The Introduction of a New Framework for the Conduct of Monetary Policy" when it terminated the quantitative easing policy in March 2006. The Policy Board continued to discuss measures to enhance the transparency of its monetary policy and to improve its communication strategy, and subsequently decided to release a statement on the "Further Enhancement of Communication Strategy under the 'Framework for the Conduct of Monetary Policy'" at the MPM on July 15, 2008.

Specifically, the Bank decided on the following measures: (1) after each MPM, to release, in addition to the policy decision, a summary of the assessment of the economic and price situation from the "two perspectives" based on the Framework for the Conduct of Monetary Policy, as well as the Bank's thinking on the future conduct of monetary policy; (2) to extend the forecast horizon for projections in the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), so that starting this October, the forecast will cover not only the current and the next fiscal years, but also the one after that; (3) to make public Policy Board members' forecasts and Risk Balance Charts on a quarterly basis; and (4) to always release MPM minutes following approval at the first subsequent meeting -- previously this approval took place either at the first subsequent meeting or the meeting following that.

I would like to comment on the third measure just mentioned. For central banks, an important challenge is how to communicate their quantitative and qualitative assessments of the economic outlook and of risk factors. At the same time, I think it would be inappropriate for central banks to frequently revise their projections and release these every time new economic data become available or something unexpected that will affect the economic outlook happens, since this will only confuse the market. The Bank decided that a period of three months would be the most appropriate interval for the release of forecasts and Risk Balance Charts. Moreover, the economic forecasts that form the basis of monetary policy decisions cannot be neatly summarized in the three figures of real GDP, the domestic corporate goods price index (CGPI), and the CPI (excluding fresh food). Rather, I think that the quantitative forecasts and Risk Balance Charts represent reference material supplementing the qualitative descriptions in the Outlook Report and the statement that follows each MPM.

An increasing number of central banks are providing a quarterly assessment of the economic and price situation as well as economic forecasts. I hope that through these measures, which are comparable to those of other major central banks, to release information as a set rather than piecemeal will contribute to further enhancing smooth communication between the Bank and the market.