Statement by Masaaki Shirakawa, Governor of the Bank of Japan, concerning the Bank's *Semiannual Report on Currency and Monetary Control* before the Committee on Financial Affairs, House of Representatives, on July 13, 2011

Introduction

The Bank of Japan submits to the Diet its *Semiannual Report on Currency and Monetary Control* in June and December. Most recently, the Bank submitted the report for the second half of fiscal 2010 on June 10, 2011. I am pleased to have this opportunity to talk about recent developments in Japan's economy and present an overall review of the Bank's conduct of monetary policy.

I. Economic and Financial Developments in Japan

I will first explain economic and financial developments in Japan.

Japan's economy faced strong downward pressure, mainly on the production side, due to the effects of the Great East Japan Earthquake that occurred on March 11. The earthquake disaster caused damage to production facilities in a wide range of areas and consequent constraints on the supply of parts and materials led to supply-chain disruptions. Moreover, serious damage to power generating facilities resulted in constraints on electric power supply. Production declined sharply mainly due to these supply-side constraints and consequently exports fell. Domestic private demand also suffered to a considerable degree, affected in part by a deterioration in business and household sentiment.

Four months after the earthquake, Japan's economic activity is picking up with a gradual easing of the supply-side constraints caused by the earthquake disaster. Production has recently shown clear signs of picking up as the restoration of supply-chain disruptions has progressed steadily at a faster-than-expected pace. At least for this summer, the electric power shortages are apparently not constraining economic activity as significantly as initially concerned, due to a strengthening of supply capacity by electric power companies and firms and households' efforts to conserve electricity and level out demand. In response to the pick-up in production, exports have started to increase. Domestic private demand has also begun to pick up, with some improvement in household and business sentiment.

Meanwhile, the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan), released by the Bank at the beginning of this month, showed that business sentiment deteriorated compared with the March *Tankan*, which appeared to have hardly reflected the effects of the disaster. As for the outlook, however, many firms, especially in the manufacturing sector, expected improvements. The June *Tankan* also showed that private firms' fixed investment was starting to pick up as evidenced by reasonably upbeat business fixed investment plans, which were revised upward from the March *Tankan*, particularly in the manufacturing sector.

With supply-side constraints easing further and production regaining traction, Japan's economy is expected to return to a moderate recovery path from the second half of fiscal 2011, backed by an increase in exports reflecting the improvement in overseas economic conditions and by a rise in demand for rebuilding.

As for financial conditions, the overnight call rate has remained at an extremely low level, and the levels of firms' funding costs have also continued to be low. Firms have continued to see financial institutions' lending attitudes as being on an improving trend. Issuing conditions for CP have continued to be favorable. In the corporate bond market, although the views of issuers and investors continue to diverge on the terms of issuance of electric power company bonds, issuing conditions have been favorable as a whole, leading to an increased variety of corporate bond issuers. In these circumstances, firms have retained their recovered financial positions on the whole, albeit with the observed weakness at some firms, mainly small ones.

On the price front, the year-on-year rate of change in the CPI (excluding fresh food) marked 0.6 percent in April and May. The rate turned positive in April for the first time in two years and four months since December 2008. As for the outlook, the year-on-year rate of change in the CPI is expected to remain slightly positive. However, the Bank recognizes that the year-on-year rate of increase in the CPI is likely to be revised downward with the base-year change scheduled for August 2011.

Based on these assessments, Japan's economy is expected to return to a sustainable growth path with price stability in the longer run.

Let me turn to risks to the outlook I have mentioned.

Regarding risks to the economic outlook, although concern over supply chains has subsided, the impact of the earthquake disaster on Japan's economy, especially through changes in household sentiment, still requires due attention. Moreover, uncertainty has increased somewhat with regard to the longer-term outlook for electricity supply constraints beyond this summer. With regard to risks to overseas economies, the effects of balance-sheet adjustments on the U.S. economy and the possible consequences of the sovereign risk problems in Europe continue to warrant attention. As for emerging and commodity-exporting economies, although many economies continue monetary tightening, inflationary pressure has not been reduced as they maintain strong growth. Therefore, there is a high degree of uncertainty about whether these economies will be able to make a soft landing by achieving price stability and economic growth at the same time.

Regarding risks to the price outlook, inflation could rise more than expected if international commodity prices increase further. There is also a possibility that the rate of inflation will deviate downward from the Bank's baseline scenario due, for example, to a decline in medium- to long-term inflation expectations.

II. Conduct of Monetary Policy

Lastly, let me explain the Bank's conduct of monetary policy.

In order for Japan's economy to overcome deflation and return to a sustainable growth path with price stability, the Bank has continued to consistently make contributions as the central bank through the three-pronged approach of pursuing powerful monetary easing consisting of comprehensive monetary easing, ensuring financial market stability, and providing support to strengthen the foundations for economic growth.

With regard to pursuing powerful monetary easing, the Bank has encouraged the overnight call rate to remain at virtually zero, namely, around 0 to 0.1 percent. Moreover, the Bank has committed itself to continue the virtually zero interest rate policy until it judges that price stability is in sight. In order to further enhance monetary easing despite the limited room left for a further decline in short-term interest rates, the Bank has implemented measures to encourage a decline in longer-term market interest rates and a reduction in various risk premiums. Specifically, the Bank has established a new framework called the Asset Purchase Program through which it conducts the fixed-rate funds-supplying operation against pooled collateral and purchases various financial assets. The assets to be purchased range from long-term government bonds and treasury discount bills to risk assets such as CP, corporate bonds, exchange-traded funds (ETFs), and Japan real estate investment trusts (J-REITs). Immediately after the earthquake, the Bank increased the amount of its asset purchases, mainly of risk assets, with a view to preventing any deterioration in business sentiment or excessive increase in risk aversion from adversely affecting economic activity. As a result, the size of the Asset Purchase Program increased to about 40 trillion yen from the initial size of about 35 trillion yen.

In addition to such pursuit of powerful monetary easing, the Bank has been implementing the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth.

Even before the earthquake, Japan's economy was faced with the challenge of a long-term downtrend in the growth potential. This has led to a protracted demand shortage in the economy and has become a fundamental cause of deflation. After the recent earthquake, meeting the challenge of strengthening the growth potential of the economy has become all the more important.

Based on these assessments, through the Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth, the Bank has been providing funds to private financial institutions that are making efforts in terms of lending and investment to increase the growth potential of Japan's economy. The funds are provided with maturities of up to four years, against collateral such as government securities, at a very low interest rate. Moreover, at the Monetary Policy Meeting held in June, the Bank decided to establish a new line of credit for the measure, through which the Bank will extend loans to financial institutions for their investments and loans with equity-like features and loans without conventional collateral or guarantees. The latter includes lending that takes movable property, such as inventories and machinery, or accounts receivables as collateral -- the so-called asset-based lending (ABL). The Bank expects that this new initiative will further enhance financial institutions' efforts to strengthen the foundations for economic growth through the use of a wider range of financial techniques.

Furthermore, after the earthquake, in order to maintain the financial intermediation functioning and secure smooth funds settlement, the Bank, in cooperation with private financial institutions, provided cash in the disaster areas and ensured the stable operation of Japan's core payment and settlement systems, including the Bank of Japan Financial Network System (BOJ-NET). With a view to ensuring stability in financial markets, the Bank also provided ample funds sufficient to meet demand in the markets over a period of successive days. Moreover, in April, it introduced the funds-supplying operation that provides financial institutions in disaster areas with a one-year loan of 1 trillion yen in total at a rate of 0.1 percent per annum, with the aim of supporting these institutions' initial efforts to meet demand for funds for restoration and rebuilding. At the same time, the Bank broadened the range of collateral that financial institutions in disaster areas can pledge to the Bank to borrow funds to ensure these institutions' funding capacity.

The Bank will continue to carefully examine the outlook for economic activity and prices, including the effects of the disaster, and take appropriate policy actions as necessary.