

# Monetary Policy

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## **I. Summary**

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## **II. Economic and Financial Developments in Fiscal 2004**

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## **III. Monetary Policy in Fiscal 2004**

- A. Overview
- B. Measures to Further Enhance the Transparency of the Bank's Monetary Policy

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## **IV. Revisions of Monetary Policy Tools**

- A. Introduction of JGS Lending Facility
- B. Acceptance of Dematerialized CP Issued by Foreign Corporations with Guarantees as Eligible Collateral and as Eligible Assets for CP Purchase Operations
- C. Other Issues

## I. SUMMARY

The Bank of Japan, as the central bank of Japan, decides and implements monetary policy.

The Bank's monetary policy is aimed at contributing to the sound development of the national economy through the pursuit of price stability, as stipulated in Article 2 of the Bank of Japan Law.

The Law stipulates that monetary policy shall be decided by the Policy Board at Monetary Policy Meetings (MPMs). At MPMs, the Board first discusses the economic and financial situation and then decides various matters relating to monetary policy, including the following: (1) the guideline for money market operations; (2) the official discount rate; (3) reserve requirement ratios; (4) the Bank's view of economic and financial developments; and (5) the types and the terms

and conditions of bills and bonds eligible for money market operations. Board decisions are announced, in principle, immediately after the meeting concerned. Discussions that take place during the course of the decision-making process are disclosed in the minutes.

Money market operations—the Bank's day-to-day provision and absorption of funds in the market—are carried out based on the guideline decided at each MPM. Monetary policy aims at achieving price stability through these operations, thereby contributing to the sound development of the national economy.

The Bank held 15 MPMs in fiscal 2004. (For the guidelines for money market operations decided at these MPMs, see Table 1.)

## II. ECONOMIC AND FINANCIAL DEVELOPMENTS IN FISCAL 2004

Japan's economy continued a recovery trend in fiscal 2004, although there seemed to be somewhat weak movements in production, particularly in IT-related sectors, in the second half of the fiscal year.

Exports showed movements indicating that they were picking up toward the end of fiscal 2004, having been more or less flat since the summer due partly to global adjustments in IT-related sectors as overseas economic growth decelerated to a sustainable pace. The decline in industrial production gradually came to a halt toward the end of the fiscal year, after displaying slight weakness since the summer due partly to larger-than-

expected inventory adjustments in IT-related sectors. Corporate profits reached their highest levels since the bursting of the economic bubble, due partly to firms' efforts to reduce costs. Against this background, business fixed investment, particularly by manufacturers, continued to increase. Housing investment was more or less flat, while public investment basically followed a downward trend.

Looking at the employment and income situation, although firms continued to restrain labor costs, the unemployment rate nevertheless declined and the number of employees increased as corporate profits

continued to increase and the extent of excess labor as perceived by firms continued to ease. Also, household income clearly stopped declining in the second half of the fiscal year. In this situation, private consumption was steady.

As for prices, the year-on-year change in domestic corporate goods prices increased from the summer onward, reflecting the increase in prices of domestic and international commodities, particularly crude oil, and tightening supply and demand conditions for materials. The rise slowed in the second half of the fiscal year, however, partly because crude oil prices fell back toward the end of 2004. The year-on-year change in consumer prices (excluding fresh food) remained slightly below zero percent. This was against the background of the following: ongoing enhancement of productivity and labor cost restraint in the corporate sector; the reduction in electricity and telephone charges against the background of deregulation; and the continued improvement in the supply-demand balance in the economy.

Policy Board members' assessment of the economic and financial situation is expressed in "The Bank's View" in the *Monthly Report of Recent Economic and Financial Developments*. (For a list of the opening sentences of "The Bank's View" in fiscal 2004, see Table 2.)<sup>7</sup>

The Policy Board also released its assessments of economic activity and prices and Policy Board members' forecasts of economic growth and inflation in the issues of the *Outlook for Economic Activity and Prices* published on April 28 and October 29, 2004, after determining their contents at the respective MPMs. Furthermore, it made interim assessments of the outlook laid out in these two publications at separate MPMs on July 12 and 13, 2004, and also on January 18 and 19, 2005. These interim assessments were published in "The Bank's View" in the *Monthly Report of Recent Economic and Financial Developments*. The text of these publications is available on the Bank's web site.

### III. MONETARY POLICY IN FISCAL 2004

#### A. Overview

At MPMs in fiscal 2004, the Bank decided to maintain its existing guideline for money market operations, i.e., it would conduct money market operations, aiming at the outstanding balance of current accounts held at the

Bank at around 30 to 35 trillion yen.

At the MPM on April 8 and 9, 2004, the Policy Board, acting on reports from the Bank's staff and subsequent discussions, decided to introduce a facility to provide the markets with Japanese government

7. "The Bank's View" is decided at the first MPM of each month and constitutes the Bank's basic view of economic and financial conditions. It is used as the basis of subsequent monetary policy decisions.

securities (JGSs) held by the Bank, as a temporary and secondary source of these. The chairman had instructed the Bank's staff to study the introduction of such a facility at the MPM on February 26, 2004 (see Section IV for details).

### **B. Measures to Further Enhance the Transparency of the Bank's Monetary Policy**

In fiscal 2004, the Bank continued efforts to present its basic thinking on the conduct of monetary policy together with its evaluation of economic and price developments in a timely and lucid manner. Such efforts included releasing interim assessments of

economic and price developments in July 2004 and January 2005, three months after the releases of the *Outlook for Economic Activity and Prices* in April and October, as well as releasing "The Bank's View" of the *Monthly Report of Recent Economic and Financial Developments* on the same day as the first MPM of the month. At the MPM on October 29, 2004, the Policy Board confirmed its basic thinking on the future conduct of monetary policy and the manner in which this should be communicated to market participants. This information was included in "The Bank's View" in the *Outlook for Economic Activity and Prices* and is as shown below.

#### **Excerpt from the *Outlook for Economic Activity and Prices* issued in October 2004**

Under the current Outlook, it is not certain whether or not the occasion will arise during fiscal 2005 to change the present monetary policy framework of using the current account balances at the Bank as the main operating target. The way the central bank conducts monetary policy depends on future developments in economic activity and prices. If higher productivity and other factors continue to contain to a large extent upward pressure on prices as the economy follows a sustainable and balanced growth path, this will likely give the Bank latitude in conducting monetary policy.

The Bank will take appropriate measures in a flexible manner in response to changes in economic and financial developments, while endeavoring to offer a lucid explanation about the assessment of economic activity and prices as well as the thinking behind the conduct of monetary policy. The Bank will continue to enhance its communication with market participants so that they will be better able to judge and predict the future conduct of monetary policy.

## **IV. REVISIONS OF MONETARY POLICY TOOLS**

### **A. Introduction of JGS Lending Facility**

At the MPM on February 26, 2004, with a view to

enhancing liquidity and maintaining the smooth functioning of the JGS markets, the Policy Board

discussed introduction of a securities lending facility to provide the markets with JGSs held by the Bank. Following this discussion, the chairman instructed the Bank's staff to look into the operational requirements of introducing such a facility and to report back to the MPM once the necessary groundwork had been laid.

Subsequent to this, at the MPM on April 8 and 9, 2004, the Bank decided to introduce the JGS lending facility.

This facility provides the markets with a temporary and secondary source of JGSs. The Bank first elicits competitive bids from market participants to decide to whom JGSs held by the Bank will be sold, and then sells them to the successful bidders with repurchase agreements. To make it clear that the facility represents a "temporary and secondary" source of JGSs, certain terms and conditions, including the following, are established: (1) the Bank shall, in principle, conduct auctions of those issues that three or more interested counterparties request the Bank to sell; and (2) the Bank shall set an upper ceiling on the selling yield.

## **B. Acceptance of Dematerialized CP Issued by Foreign Corporations with Guarantees as Eligible Collateral and as Eligible Assets for CP Purchase Operations**

At the MPM on March 15 and 16, 2005, the Bank decided to accept yen-denominated dematerialized CP issued by foreign corporations with domestic corporation guarantees as eligible collateral for the Bank's provision of credit and also to include such CP in the range of eligible assets for CP purchase operations with repurchase agreements, given that more market

participants are likely to shift from using paper CP to using dematerialized CP with the termination of the favorable treatment of the stamp tax applied to paper CP at the end of March 2005.

## **C. Other Issues**

### **1. Publication of a report on the Workshop on Securitization**

As a means of supporting market participants' efforts to ensure the sound development of the asset-backed securities (ABS) market, the Bank sponsored a series of workshops devoted to the issue of securitization, to which it invited a wide range of market participants. The first of these was held on November 7, 2003. On April 22, 2004, the Bank released a report summarizing the discussions that had taken place at the twelve meetings of the workshop.

### **2. Publication of the results of the Survey on the Securitization Market**

In order to promote greater disclosure of information regarding the ABS market, from May 31, 2004, the Bank started to release, every month, the results of its Survey on the Securitization Market, as well as a semiannual report on the securitization program. This decision was prompted by discussions at the workshop as well as requests from market participants.

Specifically, the Bank receives reports, on a voluntary basis, from relevant parties such as arrangers/sponsors and rating agencies, which provide details regarding new issues of securitized products (in particular, specifying product types and issuance programs) when these are backed mainly by assets in Japan. It was decided that the summaries of these reports were to be

made public on a regular basis.

The survey has been introduced to facilitate and enhance the efficiency with which securitized products are traded during this formative period, when there is still limited availability of relevant information. Given

this underlying objective, the Bank will discontinue these surveys at the end of March 2006, when it will also terminate purchases of ABSs. The Bank plans to encourage some private organization to take over its role in this regard.

Table 1

**Guidelines for Money Market Operations Decided by the Policy Board at Monetary Policy Meetings**

Date		Guideline	Votes
2004	Apr. 9	The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen. Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target.	Unanimous vote
	Apr. 28	As above	As above
	May 20	As above	As above
	June 15	As above	As above
	June 25	As above	As above
	July 13	As above	As above
	Aug. 10	As above	As above
	Sep. 9	As above	As above
	Oct. 13	As above	As above
	Oct. 29	As above	As above
	Nov. 18	As above	As above
	Dec. 17	As above	As above
2005	Jan. 19	As above	As above
	Feb. 17	As above	As above
	Mar. 16	As above	As above

Table 2

**Opening Sentences of "The Bank's View" in Fiscal 2004**

Date		Opening sentence
2004	Apr.	Japan's economy continues to recover gradually, and domestic demand is becoming firmer.
	May	As above
	June	Japan's economy continues to recover, and the increases in production and corporate profits are exerting positive effects on employment.
	July	Japan's economy continues to recover, with the increases in production and corporate profits exerting positive effects on employment.
	Aug.	Japan's economy continues to recover.
	Sep.	As above
	Oct.	As above
	Nov.	Japan's economy continues to recover as a whole, although the increase in exports and production seems to be coming to a pause.
	Dec.	Japan's economy continues a recovery trend, although there seem to be somewhat weak movements mainly in production.
	2005	Jan.
Feb.		As above
Mar.		Japan's economy continues a recovery trend, albeit with adjustments in IT-related sectors.