

Publication of the “Financial Markets Report*”

The Bank of Japan is releasing the first issue of its “Financial Markets Report”. The Report will be published on a semi-annual basis and will review developments in the market, the factors influencing market trends, supply-demand conditions and changes in market infrastructure.

Against the background of a rapidly changing financial and economic landscape, through the preparation and publication of this report, we would like to effectively capture the signals markets are sending out and summarize the results in a timely manner. We hope this would provide us with a common basis for exchanging views on market developments with market participants both domestically and abroad.

The Report is prepared by the Financial Markets Department.

* This is a translation of the Japanese version published on July 28.

Developments in financial markets during the first half of 2005 (Summary)

In the first half of 2005, as the Japanese economy moved sideways, market movements in Japan’s financial markets generally reflected the cautious view toward the pace of economic recovery. Long-term interest rates fell slightly, and equity prices initially rose but fell subsequently at the end of June to return to levels seen at the end of last year. In the short-term money markets, extremely accommodative conditions were maintained under quantitative easing. Favorable financing conditions also continued in the credit markets, as the impact of the widening in spreads in the US and European markets was limited. Meanwhile, in the foreign exchange markets, the US dollar strengthened reflecting relatively strong economic conditions in the US.

With regard to the outlook, while the search for more convincing signs of economic recovery continues, market movements will likely be influenced by views toward economic fundamentals including crude oil prices and overseas economic developments.

From a longer-term perspective, the following factors have formed the underlying conditions for the Japanese financial markets. They are: (1) the corporate sector’s high cash flow levels and their propensity to reduce interest-bearing liabilities; (2) reduction in equity holdings by domestic investors and increase in purchases by overseas investors; (3) growth in cross-border outward bond investments based on interest rate differentials in contrast to relatively low levels of inward bond investments, and (4) search-for-yield investment behavior under a low interest

rate environment. This fundamental trend has remained basically unchanged. However, some signs worth taking note have emerged.

The future movement of global long-term interest rates, and its possible impact on global capital flows, position taking and pricing in financial markets, requires close monitoring going forward.