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Public Relations Department
Bank of Japan
C.P.O. Box 203
Tokyo 100-8630, JAPAN
Telephone: +81-3-3279-1111
Facsimile: +81-3-3510-1374
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Statement by Toshihiko Fukui, 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 Councillors, on February 21, 2006

INTRODUCTION

The Bank of Japan submitted its *Semiannual Report on Currency and Monetary Control* for the first half of fiscal 2005 to the Diet in December 2005. I am pleased to have this opportunity to present an overall review of the Bank's conduct of monetary policy.

I. Developments in Japan's Economy

The growth of Japan's economy slowed temporarily from the second half of 2004 to the summer of 2005. Thereafter, it emerged from this pause and has continued to recover steadily.

Exports and industrial production have continued to increase. Business fixed investment has continued to increase against the background of high corporate profits. In the household sector, household income has been rising moderately, as the number of employees has been increasing and wages have picked up. With this improvement in the employment and income situation, private consumption has been steady.

Looking forward, exports are expected to continue rising against the background of the expansion of overseas economies. Domestic private demand is likely to continue increasing reflecting high corporate profits and the moderate rise in household income, while structural adjustment pressure, such as the excess debt of firms, has almost dissipated. Given that an environment in which a virtuous cycle can start operating has been established with the recovery both in domestic and external demand and in the corporate and the household sectors, the economy is likely to experience a relatively long period of growth, albeit at a moderate pace. Nevertheless, risk factors such as the continuing surge in crude oil prices and its possible effect on overseas economies should continue to be monitored closely.

On the price front, the environment influencing prices has been improving. The output gap has been narrowing moderately, as the economy continues to recover at a pace above its potential. The decline in unit labor costs has been slowing with the increases in wages, despite continued downward pressure from the rise in productivity. Various survey results show that firms' and households' expectations regarding prices are gradually being revised upward.

As for price indexes, domestic corporate goods prices registered the largest increase on a year-on-year basis since March 1990, mainly reflecting the rise in international commodity prices and the depreciation of the yen in the second half of 2005, and are expected to continue increasing. The year-on-year rate of change in consumer prices (excluding fresh food, on a nationwide basis) had been slightly negative, but posted a slight increase for two consecutive months in November and December 2005. The year-on-year rate of change is likely to record a relatively clear increase in January 2006 and thereafter as the effects from the reduction in telephone charges dissipate. A positive trend is likely to be established thereafter, as the output gap continues improving gradually and downward pressures from unit labor costs decrease.

On the financial front, the environment for corporate finance is becoming more accommodative on the whole. The issuing environment for CP and corporate bonds is favorable and the lending attitude of private banks is becoming more active. The decline in credit demand in the private sector is coming to a halt. Under these circumstances, the amount outstanding of CP and corporate bonds issued has been above the previous year's level and the year-on-year rate of increase in the amount outstanding of lending by private banks, after adjusting for the liquidation of loans and loan write-offs, has been accelerating since August 2005 when the year-on-year rate of change turned positive.

Land prices remain generally on a downtrend, but the pace of decline has been slowing recently and in some areas such as central Tokyo they have started to rise.

II. Conduct of Monetary Policy

The Bank has been providing ample liquidity based on the quantitative easing policy. At the Monetary Policy Meeting on February 8 and 9, 2006, the Policy Board decided to maintain the target range for the outstanding balance of current accounts held at the Bank at "around 30 to 35 trillion yen."

The framework of the quantitative easing policy is based on two key elements. The first element is the Bank's provision of ample liquidity to the money market so that the outstanding balance of current accounts at the Bank substantially exceeds the amount of required reserves. The second is the Bank's commitment to maintain this ample provision of liquidity until the year-on-year rate of change in the consumer price index (CPI) registers zero percent or higher on a sustainable basis.

The effects of the quantitative easing policy have been changing with developments in economic activity and prices as well as the state of the financial system. When there were strong concerns over the stability of the financial system, the Bank's ample provision of liquidity, which met financial institutions' liquidity demand, stabilized financial markets and maintained accommodative financial conditions, and thus contributed to averting a contraction in economic activity.

In the current situation, the financial system in Japan has regained stability mainly because financial institutions have mostly resolved their nonperforming-loan problems, and as a result financial institutions' precautionary demand for liquidity has declined substantially. The year-on-year rate of change in the CPI has become slightly positive recently, and therefore the policy commitment has to a significant extent lost its influence on the formation of longer-term interest rates. Thus, the stimulative effects of the quantitative easing policy on economic activity and prices are coinciding with the effects of short-term interest rates being at practically zero percent.

The effects of monetary easing are being amplified by low interest rates maintained during the improvement in economic and price conditions. Given this situation, the Bank will thoroughly examine economic activity and prices, and decide a change of the policy framework appropriately according to the commitment based on the CPI.

CONCLUSION

Japan's economy continues to recover steadily. The current economic expansion has lasted four years, since January 2002, based on the Cabinet Office's reference dates of business cycles. This already makes it the third-longest expansion phase in the post-World War II period. As for the outlook, the economy is likely to experience a relatively long period of growth, albeit at a moderate pace, and the Bank will continue its close monitoring of developments. The Bank will also continue to examine the state of the economy in each region thoroughly through such means as research conducted by its branches.

The Bank conducts monetary policy to realize sustainable growth of the economy through the pursuit of price stability. The Bank is determined to firmly support Japan's economy from the financial side to achieve sustainable growth with price stability by maintaining an accommodative financial environment, based on careful examination of developments in economic activity and prices.

Statement by Toshihiko Fukui, 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 March 10, 2006

INTRODUCTION

The Bank of Japan submitted its *Semiannual Report on Currency and Monetary Control* for the first half of fiscal 2005 to the Diet in December 2005. I am pleased to have this opportunity to present an overall review of the Bank's conduct of monetary policy. At the Monetary Policy Meeting (MPM) held on March 8 and 9, 2006, the Bank decided to terminate the quantitative easing policy and shift the operating target of money market operations from the outstanding balance of current accounts at the Bank to a short-term interest rate, namely, the uncollateralized overnight call rate. Today, I will explain recent developments in economic activity and prices, which are the background to the decisions, and the Bank's conduct of monetary policy.

I. Developments in Japan's Economy

Japan's economy continues to recover steadily.

Exports and industrial production have continued to increase. Business fixed investment has continued to increase against the background of high corporate profits. In the household sector, household income has been rising moderately, as the number of employees has been increasing and wages have picked up. With this improvement in the employment and income situation, private consumption has become solid.

Looking forward, exports are expected to continue rising against the background of the expansion of overseas economies. Domestic private demand is likely to continue increasing reflecting high corporate profits and the moderate rise in household income, while structural adjustment pressure, such as the excess debt of firms, has almost dissipated. Given that an environment in which a virtuous cycle can start operating has been established with the recovery both in domestic and external demand and in the corporate and the household sectors, the economy is likely to experience a sustained recovery. Nevertheless, risk factors such as the continuing surge in crude oil prices and its possible effect on overseas economies should continue to be monitored closely.

The environment for prices has become favorable reflecting the continuing economic recovery. The year-on-year rate of change in the consumer price index (CPI; excluding fresh food, on a nationwide basis) has turned slightly positive since November 2005 and recorded a relatively clear increase in January 2006. The output gap is gradually narrowing, and unit labor costs generally face weakening downward pressures. Furthermore, firms and households are shifting up their expectations for inflation. In this environment, year-on-year changes in the CPI are expected to remain positive. Meanwhile, domestic corporate goods prices have increased on a year-on-year basis mainly reflecting the rise in international commodity prices, and are expected to continue increasing.

On the financial front, the environment for corporate finance is becoming more accommodative on the whole. The lending attitude of private banks is becoming more active and the decline in credit demand in the private sector is coming to a halt. Under these circumstances, the year-on-year rate of increase in the amount outstanding of lending by private banks, after adjusting for the liquidation of loans and loan write-offs, has been accelerating since August 2005 when the year-on-year rate of change turned positive.

II. Conduct of Monetary Policy

In March 2001, with a view to preventing a sustained decline in prices and preparing the basis for sustainable growth, the Bank introduced the quantitative easing policy. The Bank had supplied extremely ample liquidity under this policy, with the current account balance at the Bank as the main operating target. It also made a clear commitment to maintain the policy until the CPI (excluding fresh food, on a nationwide basis) registers stably zero percent or an increase year on year. The Bank had maintained firmly the policy according to this commitment for about five years.

Under such circumstances, Japan's economy has improved considerably and continues to recover steadily. Concerning prices, year-on-year changes in the CPI have turned positive and are expected to remain so.

Given the improvement in economic and price conditions, at the MPM held on March 8 and 9, 2006, the Bank decided to terminate the quantitative easing policy and shift the operating target of money market operations from the outstanding balance of current accounts at the Bank to the uncollateralized overnight call rate. The Bank also introduced a new framework for monetary policy conduct, including clarification of its thinking on price stability with a view to ensuring the continued transparency of monetary policy.

Specifically, the Bank decided to set the following guideline for money market operations for the inter-meeting period: The Bank of Japan will encourage the uncollateralized overnight call rate, which is the operating target of money market operations, to remain at effectively zero percent. Given that the effects of short-term interest rates being zero had already become the main effect of the quantitative easing policy on economic activity and prices, there will be no abrupt change as a result of the policy decision. On the future path of monetary policy, there will be a period in which the overnight call rate is at effectively zero percent, followed by a gradual adjustment in the light of developments in economic activity and prices. In this process, if it is judged that inflationary pressures are restrained as the economy follows a balanced and sustainable growth path, an accommodative monetary environment ensuing from very low interest rates will probably be maintained for some time.

The Bank also decided to introduce a new framework for the conduct of monetary policy. Three elements underlie the new framework. First, the Bank will review its basic thinking on price stability, and disclose a level of inflation rate that its Policy Board members currently understand as price stability from a medium- to long-term viewpoint, in their conduct of monetary policy. Second, the Bank will examine economic activity and prices from two perspectives: examining economic activity and prices one to two years in the future; and examining, in a longer term, risk factors that are most relevant to the conduct of monetary policy. And third, the Bank will, in the light of deliberations from the two perspectives just described, outline the current view on monetary policy and disclose it periodically.

Under the new framework, the Bank will continue to conduct monetary policy appropriately in a highly transparent manner and contribute to sustainable economic growth with price stability.

New Framework for the Conduct of Monetary Policy: Toward Achieving Sustainable Economic Growth with Price Stability

*Speech Given by Toshihiko Fukui,
Governor of the Bank of Japan*

INTRODUCTION[1]

At the Monetary Policy Meeting (MPM) held on March 8 and 9, 2006, the Bank of Japan decided to terminate the quantitative easing policy, which had been maintained during the five years since March 2001. The Bank shifted the operating target of money market operations from the outstanding balance of current accounts at the Bank to a short-term interest rate, namely, the uncollateralized overnight call rate. It also introduced a new framework for the monetary policy conduct, including clarification of its thinking on price stability.

Today, I will focus on the background to the termination of the quantitative easing policy by looking back on economic and financial developments during the past few years, and explain the Bank's future monetary policy conduct.

Embarking on a Sustainable Growth Path

Japan's economy continues to recover steadily. The current economic expansion started in January 2002 and has lasted for more than four years, according to the Cabinet Office's reference dates of business cycles. The recent recovery is well balanced in terms of the balance between domestic and external demand, and also between the corporate and household sectors. Although the recovery is not accelerating, the foundation for economic growth is solid, and its resistance to various external shocks has been increasing. The present phase of the recovery is the third since the bursting of the economic bubble. Unlike the previous two phases, this time we may reasonably expect the current expansionary phase to last longer and to be more sustainable. Japan's economy has, at last, succeeded in emerging from its prolonged adjustment phase, which continued for more than a decade, and has embarked on a sustainable growth path with price stability.

Several factors support this view. In addition to external factors, such as the continuing expansion of overseas economies, on the domestic side structural reforms have made significant progress in both the business and financial sectors. Moreover, the positive effects of the recovery are spreading to the household sector. I will now discuss these contributing factors and then go into some detail regarding the sustainability of the current economic recovery.

Progress in Structural Reforms

The most important factor contributing to the achievement of sustained economic recovery has been the elimination of the burdens, or adjustment pressures, in the corporate sector and the financial system, which have hindered the Japanese economy's movement to a sustainable growth path ever since the bursting of the economic bubble.

As a result of stringent corporate restructuring efforts that lasted for more than a decade, the excesses in debt, employment, and production capacity—the so-called "three excesses"—have for the most part been dispelled and resolved. According to the latest *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the number of firms perceiving their production capacity as excessive is almost equal to the number perceiving it as insufficient for the first time since the early 1990s. The number of firms perceiving their holdings of labor as insufficient has already exceeded the number perceiving them as excessive, indicating that firms perceive a tightening of the labor market. This tightness is also evidenced by the ratio of job offers to applicants, which has exceeded 1.00. Turning to firms' debt levels, the ratio of interest-bearing debt to sales peaked out around 1993, and is currently as low as that seen in the mid-1980s, before the bubble era.

While taking measures to resolve the "three excesses," firms have been reviewing their business lines based on the principle of "selection and concentration" in the face of intensified global competition. More specifically, firms have adopted an active management approach by concentrating on strategic areas of business and establishing business tie-ups to improve their ability to generate high-value-added products and services. As a result, firms have succeeded in substantially improving their profitability. Corporate profits have increased for the three consecutive years from fiscal 2002, and are expected to continue to increase in the current fiscal year. Firms' ratio of current profits to sales has already exceeded the peak marked during the bubble era. Using the high level of corporate profits, firms are actively investing in research and development and expanding production capacity in order to boost

1. This article is excerpted and translated from a speech given by Toshihiko Fukui, Governor of the Bank of Japan, to the Japan Chamber of Commerce and Industry in Tokyo on March 16, 2006.

market competitiveness. These activities are evident in increases in business fixed investment, regardless of the type and size of firm.

Improvements are also notable in the financial system. The nonperforming-loan (NPL) problem that has plagued Japan's economy for so long has by and large been resolved, and the stability of the Japanese financial system has been restored. The lending attitude of financial institutions has become more active as a result of improvements in their profitability and capital adequacy ratios due to the decrease in the amount of NPLs. The amount outstanding of lending by private banks, which had long been on a downward trend, finally turned upward on a year-on-year basis in August 2005 after an adjustment for securitization of loans and loan write-offs. Since then, the pace of increase has been gradually accelerating. In the previous two recovery phases, weakness in the financial system hindered the economy from moving onto a sustainable growth path. At present, however, the financial system has recovered to a level of soundness sufficient to firmly support the achievement of sustained economic growth.

Spread of Improvement in the Corporate Sector to the Household Sector

In order to realize a sustainable economic recovery, it is important for a virtuous cycle to operate in the economy, wherein the improvement in income of the corporate sector spreads to the household sector, and this in turn feeds back to the corporate sector. Unfortunately, in past recovery phases, such a virtuous cycle did not fully operate, as both the corporate sector and the financial system were subject to structural adjustment pressure. In contrast, in the current recovery phase, apparent improvement in the employment and income situation has been observed since the beginning of 2005, and a longer and more sustainable recovery is expected in the household sector.

Firms have been increasing their numbers of employees, as the adjustment in excessive holdings of labor has progressed. Initially, they relied mainly on part-time workers in order to restrain labor costs, but firms have begun to gradually increase their numbers of regular employees, as the labor market has tightened. Wages per worker have also been rising, reflecting such conditions in the labor market. Specifically, regular payments have recently begun to increase in addition to continuing growth in overtime payments and bonus payments. This improvement in the employment and income situation, coupled with a rise in stock prices and an increase in dividend income, has contributed to income growth in the household sector. With such income conditions, private consumption has been solid. It is expected to remain so, supported by the increase in household income. This development is expected to accelerate the virtuous cycle further as the firmness in private consumption feeds back to the corporate sector.

As seen from what I have described, Japan's economy continues its solid recovery, but this recovery is often said to not apply evenly across small firms and regional economies. In fact, the degree of recovery still varies according to size of firm and region.

The economic recovery has indeed been spreading steadily, with both domestic and external demand continuing to increase. The *Tankan* indicated that business conditions at not only large firms but also small and medium-sized ones have been improving. The Bank's branches conduct research and interviews so as to grasp the state of regional economies, and the results are presented at the meeting of general managers of the Bank's branches. The results show that, although there still is a difference in the degree of recovery, all regional economies are showing improvement. The Bank will continue to pay due attention to future developments in regional economies.

Improvement in the Environment for Prices

The environment for prices has become favorable reflecting the continuing economic recovery. The year-on-year rate of change in the consumer price index (CPI, excluding fresh food) had been negative since 1998, but returned to 0.0 percent in October 2005 and turned positive in November. According to the figure released on March 3, 2006, it rose further in January 2006, reaching 0.5 percent. This was partly attributable to the dissipation of temporary factors such as the reduction of telephone charges implemented in 2005 and also to high crude oil prices, but more importantly, fundamental factors that affect price developments clearly began to improve and started to exert upward pressure on prices.

First, the supply-demand balance is improving gradually and improvement is expected to continue, as the economy continues to recover at a pace slightly above its potential. Second, although unit labor costs continue to be driven down by the productivity increase, with wages beginning to rise, the rate of decline has been diminishing and this trend is expected to continue. And third, firms' and households' expectations of inflation have been gradually revised upward, as indicated by various surveys.

All of this indicates that the environment for prices has changed dramatically from the past, when a substantial output gap exerted downward pressure on prices. As the economy is expected to continue to recover steadily with a balance being maintained between domestic and external demand and between the corporate and household sectors, a positive trend in the year-on-year rate of change in consumer prices is projected to be established, albeit with some fluctuations.

As I have explained, Japan's economy has achieved substantial improvement, in terms of both economic activity and prices, and this implies that the Bank should respond to the improvement by changing its conduct of monetary policy.

Effects of the Quantitative Easing Policy

The Bank displayed its resolve in continuing the quantitative easing policy for five years after introducing it in March 2001. At the time, Japan's economy was in a recessionary phase triggered by the collapse of the IT bubble around the globe. Financial institutions in Japan were also burdened by massive NPLs, and there was a high level of public anxiety concerning the stability of the financial system. In these circumstances, the economy faced a severe challenge, the potential risk of falling into a vicious cycle, or so-called deflationary spiral, in which a fall in demand reflecting deterioration of the economy causes a decline in prices and this in turn leads to a further fall in demand. To counter this situation, the Bank acted decisively and introduced the quantitative easing policy, which was unprecedented in the history of any central bank, with the aim of preventing a continuing fall in prices and establishing a foundation for achieving sustainable economic growth. I would like to elaborate on what the quantitative easing policy has contributed to Japan's economy over the past five years.

The quantitative easing policy consisted of two pillars: provision by the Bank of ample liquidity to raise the outstanding balance of current accounts at the Bank above the amount of reserves financial institutions are required to hold, namely, required reserves; and a commitment by the Bank to continue to provide ample liquidity until the year-on-year rate of change in the CPI (excluding fresh food) registered zero percent or higher on a sustainable basis.

Provision of ample liquidity exceeding required reserves reduced very short-term interest rates to effectively zero percent and dispelled financial institutions' liquidity concern. After the introduction of the quantitative easing policy, there was no occurrence of any large-scale credit crunch, such as was observed in 1997 and 1998, and stability in financial markets was maintained despite the materialization of various shocks, including the terrorist attacks in the United States and the Iraq war as well as the injection of public funds into a major Japanese bank when the financial system was fragile.

The Bank's commitment to continue the quantitative easing policy generated expectations that the zero interest rate environment would continue for a certain period of time while consumer prices continued to decline. This is referred to as the "duration effect," that is, the effect of the Bank's commitment regarding the duration of the policy. As a result of this duration effect, the Bank's commitment contributed to keeping short- to medium-term interest rates stable at low levels.

The policy effects of dispelling the liquidity concern as well as keeping interest rates low and stable have created an accommodative environment not only in the money market and capital markets but also in corporate finance activities. Bank lending rates, for example, have continued to decline partly reflecting the decrease in the credit premium, and are around historically low levels, despite the ongoing economic recovery.

As mentioned earlier, Japanese firms, after strenuous efforts, have tackled structural problems such as the "three excesses," and are becoming increasingly active in undertaking business fixed investment. The accommodative financial environment created by the quantitative easing policy has been firmly supporting such developments. It could be said that the policy has contributed to improving the rate of return on capital and to raising corporate profits, as it enabled lending rates to decline even while the economic outlook was gradually brightening. These improvements in the corporate sector have, with a certain lag, been exerting positive effects on the household sector, thereby supporting the continuing economic recovery and the favorable environment for price developments.

The Bank's quantitative easing policy played a significant role in the recovery of Japan's economy and in the improvement in price developments. However, amid recent economic and financial circumstances, both the effect of the quantity of liquidity to dispel liquidity concern and the duration effect through which the Bank's commitment influences interest rates are considered to have played themselves out. As the financial system has regained stability, liquidity demand at financial institutions has declined, reducing the need for the provision of funds at a level well over required reserves. In addition, the duration effect of the policy commitment has been gradually diminishing with the shortening of the expected duration of the quantitative easing policy in line with the improvement in price developments. Ultimately, the duration effect ceases to exist when the criterion that the year-on-year rate of change in the CPI is registering zero percent or higher on a sustainable basis is fulfilled. In short, the effects of the quantitative easing policy on economic activity and prices had already become essentially equivalent to those of an interest rate policy targeting a short-term interest rate of zero percent prior to the termination of the quantitative easing policy.

Background to the Termination of the Quantitative Easing Policy

In this situation, the Bank decided to terminate the quantitative easing policy at the MPM held on March 8 and 9, 2006. The Bank decided to change the operating target of money market operations from the outstanding balance of current accounts at the Bank to the uncollateralized overnight call rate, and to set the guideline for money market operations for the intermeeting period as follows: "The Bank of Japan will encourage the uncollateralized overnight call rate to remain at effectively zero percent."

The year-on-year rate of change in the CPI has been registering zero percent or above for the four consecutive months since October 2005, and a positive trend in the rate of change in the CPI is projected to be established. Economic developments underlying the CPI also indicate that Japan's economy is likely to experience a sustained period of expansion with domestic and external demand well in balance. Based on these developments in economic activity and prices, the Bank judged that the commitment that it would continue the quantitative easing policy until the year-on-year rate of change in the CPI registers zero percent or higher on a sustainable basis had been fulfilled, and that it was therefore appropriate to terminate the unprecedented quantitative easing policy.

It must be stressed that the termination of the quantitative easing policy does not signify a tightening of monetary policy. As I have explained, the policy effects of the quantitative easing policy have already become essentially equivalent to those of an interest rate policy targeting a short-term interest rate of zero percent. Since the Bank will encourage the uncollateralized overnight call rate to remain at effectively zero percent based on the new guideline for money market operations, there will be no abrupt change in monetary policy in terms of the stimulative effects of the quantitative easing policy on economic activity and prices. The effects of short-term interest rates being at effectively zero percent have increased gradually with the upturn in economic activity and prices, and they are expected to become stronger while the current guideline is maintained. Although the level of interest rates depends on developments in economic activity and prices as well as in financial markets, if it is judged that inflationary pressures are restrained as the economy follows a balanced and sustainable growth path, then the accommodative monetary environment ensuing from very low interest rates will probably be maintained for some time. The Bank will continue to offer firm support to the economy by maintaining accommodative monetary conditions.

Some might question why the Bank should terminate the quantitative easing policy if the policy effects are equivalent to those of an interest rate policy targeting a short-term interest rate of zero percent. However, the Bank made a clear commitment when it introduced the quantitative easing policy that it would continue the policy until the year-on-year rate of change in the CPI registered zero percent or higher on a sustainable basis, and market participants have been conducting transactions on this premise. The duration effect of the policy commitment could not have been achieved without market participants' confidence in the commitment. In this regard, the termination of the quantitative easing policy once the Bank judged the commitment to have been fulfilled contributes to enhancing monetary policy transparency and in turn the effectiveness of monetary policy in the long term. Putting this another way, if the Bank had continued to conduct monetary policy in line with an operating target that had already essentially lost its effectiveness, this could well have caused not only increased uncertainty in financial markets but also damage to the transparency of monetary policy.

Conduct of Money Market Operations for the Immediate Future

In conducting money market operations in the immediate future, the Bank will reduce the outstanding balance of current accounts toward a level in line with required reserves according to the new guideline for money market operations. It should be borne in mind, however, that as financial institutions have managed liquidity against the backdrop of large amounts of current account balances and extensive funds-supplying operations by the Bank for a prolonged period under the quantitative easing policy, the functioning of the money market has been somewhat impaired. As a result, financial institutions may have difficulties carrying out smooth fund management. Given these circumstances, the Bank's reduction of the current account balance will be implemented taking full account of conditions in the money market. How long it will take for the Bank to reduce the current account balance depends on the situation in the money market, but it is reasonable to expect the reduction to be carried out over a period of a few months. With respect to the complementary lending facility, which allows financial institutions to borrow short-term funds from the Bank at their request up to the amount of the collateral they pledged in advance, the Bank decided to keep the loan rate unchanged at 0.1 percent, its level prior to the termination of the quantitative easing policy. This means that the uncollateralized overnight call rate, which will be effectively zero percent in accordance with the new guideline for money market operations, will basically not exceed this ceiling of 0.1 percent even if it surges temporarily. Reduction of the outstanding balance of current accounts at the Bank will be managed through short-term money market operations. With respect to outright purchases of long-term Japanese government bonds, these will continue at the current amounts and frequency for some time, with due regard for the future condition of the Bank's balance sheet.

Introduction of a New Framework for the Conduct of Monetary Policy

Following the latest MPM, the Bank announced the introduction of a new framework for the conduct of monetary policy, with a view to ensuring the transparency of its policy conduct given the shift from the quantitative easing policy to an interest rate policy.

Under the quantitative easing policy, the Bank conducted monetary policy in line with a commitment based on the CPI. The commitment was unprecedented in that it linked the conduct of monetary policy directly to a specific economic indicator, namely, the CPI. With the aim of generating monetary easing effects in a situation where there was no room to further reduce short-term interest rates, the Bank introduced this unprecedented policy to affect the formation of interest rates, in spite of acknowledging the concomitant sacrifice in the flexibility with which it would be able to conduct monetary policy. Such a policy measure had never previously been adopted by any central bank, and it may safely be seen as a monetary policy innovation designed by the Bank of Japan. As I explained earlier, the Bank's commitment regarding the duration of the policy had significant positive effects that operated by keeping short- to medium-term interest rates stable at low levels and maintaining an accommodative environment for corporate financing. However, at the same time, the policy to some extent undermined the pricing function of financial markets.

With the prospects for sustainable economic growth with long-term price stability, monetary policy in general should be conducted in a forward-looking manner—in other words, it should be implemented taking future developments in economic activity and prices fully into consideration—and it should be both flexible and timely. In the current situation where the economy is emerging from a prolonged period of structural adjustment and moving toward a path of sustainable growth, a new framework should be introduced to ensure that monetary policy is conducted both appropriately and with sufficient transparency. Given the Bank's thinking about the conduct of monetary policy, market participants, for their part, should have their own views on interest rate developments and thereby make decisions on financial transactions, by forecasting the future course of monetary policy based on their assessment of economic activity and prices. Such a process will facilitate the proper functioning of pricing mechanisms in financial markets and in turn generate economic dynamism through the efficient allocation of funds.

Three elements underlie the new framework for the conduct of monetary policy.

First, the Bank has clarified its thinking on price stability, which is a stated objective of monetary policy. Specifically, the Bank has made public its basic thinking on price stability, and, as regards the conduct of monetary policy, it has disclosed a level of the inflation rate that its Policy Board members currently understand as price stability from a medium- to long-term viewpoint.

Second, the Bank has explained the two perspectives from which it examines economic activity and prices in determining how to conduct monetary policy.

Third, the Bank has decided that, after deliberations from these two perspectives, it will outline its thinking on the conduct of monetary policy for the immediate future, and, as a rule, disclose it periodically in the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report).

Now I will elaborate on these three elements.

Clarifying the Bank's Thinking on Price Stability

The Bank of Japan Law stipulates the objective of monetary policy as "contributing to the sound development of the national economy" "through the pursuit of price stability." In accomplishing this stated objective, it is thus very important for the Bank to clearly indicate to the public its thinking on price stability.

Price stability can be defined as a state where various economic agents including households and firms are able to make decisions regarding economic activities such as consumption and investment without being concerned about fluctuation in the general price level. When considering what constitutes price stability for the purposes of conducting monetary policy, central banks should take full account of the distinctive features of their countries' economic structures and how these influence the public's view of prices. In the case of Japan, one noteworthy feature regards the average rate of inflation, which, over the last a few decades, has been lower than in major overseas economies. Specifically, average inflation rates for major countries from 1985 to 2005, measured by the CPI, are as follows: 3.2 percent for the United States, 2.9 percent for the United Kingdom, 1.8 percent for Germany, and 0.6 percent for Japan. As the Japanese economy has had a protracted experience of low inflation since the 1990s, the rate of inflation at which households and firms perceive price stability seems to be low, and economic decisions are likely to be made on the premise of a similarly low-inflation environment. These features should be taken duly into consideration when conducting monetary policy.

At the latest MPM, taking into account the points I have described, there was a discussion of the level of inflation that each Policy Board member, in conducting monetary policy, currently understands as price stability from a medium- to long-term viewpoint. Such a level is referred to as a member's "understanding of medium- to long-term price stability." There was a range of views among the Policy Board members, which seemed to reflect differences between their views on the Japanese economic structure, as well as differences in their assessments of the costs of inflation and deflation. They concurred, however, that, in the current situation, the level in Japan was somewhat lower than in major overseas economies. They also agreed that, by making use of the rate of year-on-year change in the CPI to describe the understanding, an approximate range between zero and 2 percent was generally consistent with the distribution of each member's understanding of medium- to long-term price stability. Most Policy Board members' median figures fell on both sides of 1 percent. Given that the "understanding of medium- to long-term price stability" may change gradually, reflecting changes in the economic structure such as further progress in globalization and innovations in information and communication technologies, as a rule, Policy Board members will review it annually.

Examining Economic Activity and Prices from Two Perspectives

Having clarified its thinking on price stability, the Bank's next step was to decide how to examine economic activity and prices in light of such thinking, and then to devise ways to incorporate such analysis into its conduct of monetary policy. Although it is very important to clarify the Bank's thinking on price stability, this in itself is not sufficient to develop an actual policy guideline for conducting monetary policy. The most significant issue facing any central bank, regardless of whether it has adopted inflation targeting or not, is how to provide information that will make it easier for the public to predict the future course of monetary policy and so enhance its effectiveness. For instance, suppose a central bank conducts policy based on certain mechanical rules. Although such rules would in themselves enhance the transparency of the policy, they would be incapable of coping flexibly with the various economic shocks hitting the economy. They would therefore fail to meet the original purpose of enhancing transparency, which is to improve the effectiveness of monetary policy. To date, the Bank has released its assessment of the current state and outlook for economic activity and prices through the *Monthly Report of Recent Economic and Financial Developments* and the Outlook Report. Henceforth, the Bank has decided to supplement this assessment with additional examinations of economic activity and prices from the following two perspectives, which are of particular relevance to the conduct of monetary policy, and then to release them.

The first perspective involves examining, as regards economic activity and prices one to two years in the future, whether the outlook deemed most likely by the Bank follows a path of sustainable growth under price stability.

It should be added that, in order to implement the appropriate policy for achieving sustainable growth and price stability, it is not sufficient merely to assess the economic and price situation according to the first perspective. Needless to say, any forecast entails uncertainty. It is for this reason that the Bank's Outlook Report contains detailed descriptions with regard to upward and downward risks affecting the scenario deemed most likely by the Bank. Among risk factors, there are those that will have a significant impact on economic activity and prices should they materialize, even though the likelihood of materialization is low. Such risks include that of falling into a deflationary spiral, or conversely, the risk of sparking inflation or generating an asset price bubble. In conducting monetary policy, the Bank needs to do its utmost to prevent the materialization of such potential risks.

The economic projection described in the Outlook Report covers a period of about one and a half to two years. There could, however, be risk factors that might affect economic activity and price development in the medium to long term, beyond the Outlook Report's projection period. Experience inside and outside Japan shows that wide swings in asset prices and significant changes in the financial environment, including those affecting the intermediation function of financial institutions, may impact on economic activity and price development with a considerable lag. In addition, when the public's longer-term expectations of inflation change, this can have a significant impact on the existing relationship between economic activity and prices.

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. Major central banks seem to share the opinion that to conduct monetary policy putting too much emphasis on achieving price stability in the short term results in large swings in economic activity, and this in turn impedes long-term price stability and the sound development of the economy.

Conduct of Monetary Policy for the Immediate Future

Lastly, as the third element of the new framework for the conduct of monetary policy, the Bank will outline its current view on monetary policy in light of its deliberations from the two perspectives I have described, and disclose it periodically, as a rule in the Outlook Report. On the current occasion, the Bank decided to release the results of its deliberations ahead of the release of the April Outlook Report, to coincide with the timing of the termination of the quantitative easing policy.

Looking ahead, in considering the central scenario for economic activity and prices, there is a high probability of realizing sustainable growth under price stability. As I mentioned earlier, however, against the backdrop of improving corporate profitability and a positive turn in price developments, there is a possibility that the monetary policy stimulus to economic activity and prices could be amplified via, for example, a decline in real interest rates. If the stimulus becomes too strong, there is a risk that, even if current prices are stable, investment activity could become excessive, resulting in volatile economic fluctuations. Moreover, this could negatively affect the prospects for sustainable economic growth with long-term price stability. In its conduct of monetary policy, the Bank should pay attention to this as well as other long-term risks.

Bearing this in mind, I would now like to touch on the Bank's thinking regarding the future path of monetary policy. There will be a period in which the uncollateralized overnight call rate is at effectively zero percent, followed by a gradual adjustment in light of developments in economic activity and prices. In this process, if the risk I have described remains muted, in other words, if it is judged that inflationary pressures are restrained as the economy follows a balanced and sustainable growth path, an accommodative monetary environment ensuing from very low interest rates will probably be maintained for some time.

This completes my explanation of the new framework for conducting monetary policy introduced last week. The Bank and other central banks make continuous efforts to clearly explain their thinking on the conduct of monetary policy to market participants and the public. The specific method employed, however, differs according to their economic environment and institutional framework. At the Bank, in introducing a new framework we studied practices at other central banks and adopted the elements that were considered relevant, but most importantly we devised the most appropriate framework for clearly explaining the conduct of monetary policy in light of Japan's economic situation. Although the new framework is different from, for example, inflation targeting, where a numerical target for price stability is set and is to be achieved within a certain time frame, nevertheless the new framework improves the transparency of the Bank's monetary policy objective by indicating its thinking on what constitutes price stability. Taking this into account, the Bank will examine economic activity and prices from the two perspectives explained earlier, and will release its view on the conduct of monetary policy for the immediate future. For Japan's economy, which has emerged from a prolonged recession and is entering a new phase, the Bank believes that the new policy framework is the most suitable for enhancing transparency and conducting monetary policy appropriately. This new framework is also expected to contribute to smooth price formation in financial markets where participants find themselves in uncharted territory with the termination of the unprecedented quantitative easing policy.

CONCLUSION

Today, I have elaborated on the current state of Japan's economy, which is entering a new phase, as well as providing details about the new framework for conducting monetary policy introduced last week. Under the new framework, the Bank will continue to conduct monetary policy appropriately, responding flexibly to changes in economic activity and prices, and to contribute to sustainable economic growth and price stability.

Publications of the Monetary Policy Meeting on January 19 and 20, 2006

Minutes

Released on March 14, 2006

The Bank's View of Recent Economic and Financial Developments

Released on January 20, 2006

English translations prepared by the Bank's staff based on the Japanese originals

MINUTES OF THE MONETARY POLICY MEETING ON JANUARY 19 AND 20, 2006

A Monetary Policy Meeting of the Bank of Japan Policy Board was held in the Head Office of the Bank of Japan in Tokyo on Thursday, January 19, 2006, from 2:00 p.m. to 3:48 p.m., and on Friday, January 20, from 9:00 a.m. to 12:50 p.m.[1]

Policy Board Members Present

Mr. T. Fukui, Chairman, Governor of the Bank of Japan
Mr. T. Muto, Deputy Governor of the Bank of Japan
Mr. K. Iwata, Deputy Governor of the Bank of Japan[2]
Ms. M. Suda
Mr. S. Nakahara
Mr. H. Haru
Mr. T. Fukuma
Mr. A. Mizuno
Mr. K. G. Nishimura

Government Representatives Present

Mr. K. Akaba, Senior Vice Minister of Finance, Ministry of Finance[3]
Mr. K. Sugimoto, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance[4]
Mr. Y. Nakajo, Vice Minister for Policy Coordination, Cabinet Office[3]
Mr. J. Hamano, Director General for Economic and Fiscal Management, Cabinet Office[4]

Reporting Staff

Mr. E. Hirano, Executive Director (Assistant Governor)
Mr. M. Shirakawa, Executive Director
Mr. A. Yamamoto, Executive Director
Mr. H. Yamaguchi, Director-General, Monetary Affairs Department
Mr. S. Uchida, Senior Economist, Monetary Affairs Department
Mr. H. Nakaso, Director-General, Financial Markets Department
Mr. H. Hayakawa, Director-General, Research and Statistics Department
Mr. K. Momma, Deputy Director-General, Research and Statistics Department
Mr. A. Horii, Director-General, International Department

Secretariat of the Monetary Policy Meeting

Mr. Y. Nakayama, Director-General, Secretariat of the Policy Board
Mr. T. Kozu, Adviser to the Governor, Secretariat of the Policy Board
Mr. K. Murakami, Director, Secretariat of the Policy Board
Mr. T. Kato, Senior Economist, Monetary Affairs Department
Mr. K. Masaki, Senior Economist, Monetary Affairs Department

I. Summary of Staff Reports on Economic and Financial Developments[5]

A. Money Market Operations in the Intermeeting Period

The Bank conducted market operations in accordance with the guideline decided at the previous meeting on December 15 and 16, 2005.[6] The outstanding balance of current accounts at the Bank moved in the 31–35 trillion yen range.

B. Recent Developments in Financial Markets

The weighted average of the uncollateralized overnight call rate was at around zero percent, except on the last business day of 2005 when it showed a slight increase. As for interest rates on term instruments,

1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on March 8 and 9, 2006 as "a document which contains an outline of the discussion at the meeting" stipulated in Article 20, Paragraph 1 of the Bank of Japan Law of 1997. Those present are referred to by their titles at the time of the meeting.
2. Mr. K. Iwata was absent from 2:00 p.m. to 3:12 p.m. on January 19 to attend a meeting of the Ministerial Council, which discussed issues including the Cabinet Office's *Monthly Economic Report*.
3. Messrs. K. Akaba and Y. Nakajo were present on January 20.
4. Messrs. K. Sugimoto and J. Hamano were present on January 19.
5. Reports were made based on information available at the time of the meeting.
6. The guideline was as follows:

   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. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

both Euro-yen rates and yields on treasury bills (TBs) and financing bills (FBs) were stable at low levels.

Japanese stock prices rose substantially through mid-January, mainly reflecting increased expectations of economic recovery, and fell thereafter in response to news reports concerning certain firms. The Nikkei 225 Stock Average was recently moving in the range of 15,500–16,000 yen.

Long-term interest rates had basically been more or less flat, and were moving in the range of 1.45–1.50 percent recently.

The yen depreciated against the U.S. dollar through the year-end, as the dollar was purchased, mainly by domestic investors. It appreciated thereafter due mainly to market participants' speculation regarding U.S. monetary policy. It was recently being traded in the range of 114–116 yen to the dollar.

C. Overseas Economic and Financial Developments

The U.S. economy continued to expand steadily, at a pace around its potential growth rate, led mainly by household spending and business fixed investment. Although prices had recorded a high increase temporarily due to the elevated energy prices, the inflation rate was increasing moderately in terms of the basic trend.

In the euro area, although the economy remained somewhat sluggish, the momentum for recovery had been gradually increasing as evidenced by the pickup in exports and production partly due to depreciation of the euro.

With regard to East Asian economies, in China both domestic and external demand continued to expand strongly. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole, although negative effects of high energy prices could be seen in some economic activity.

In U.S. and European financial markets, long-term interest rates declined, reflecting moderate movements in inflation-related indicators and an increase in market expectations that the Federal Reserve would stop raising the interest rate in the near future. Stock prices rose, reflecting an increase in expectations for favorable earnings reports. In financial markets in most of the emerging economies, their currencies and stock prices rose and yield differentials between their sovereign bonds and U.S. Treasuries narrowed.

D. Economic and Financial Developments in Japan

1. Economic developments

Exports had continued to increase against the background of the expansion of overseas economies. Exports to China, which had been lacking in momentum until the middle of 2005, posted a solid increase in the October–November period, particularly in IT-related goods and automobile-related goods, after having risen notably in the July–September quarter. Exports were expected to continue rising against the background of the further expansion of overseas economies, especially in the United States and East Asia.

In the corporate sector, business fixed investment had continued to increase, and was expected to keep increasing, since the expansion in domestic and external demand and the high level of corporate profits were likely to be maintained.

The uptrend in production had recently become evident again, although production had repeatedly exhibited fluctuations due to statistical factors until the middle of 2005. By industry, production of electronic parts and devices posted brisk gains, and that of general machinery and transport machinery also stepped up. Production was expected to continue its uptrend, as overseas economies continued to grow and the foundation for a recovery in domestic demand was solid.

Inventories had been relatively high in materials industries. However, high-value-added products remained in a favorable supply-demand condition and the effects of inventory adjustments in materials industries seemed to be limited.

As for the employment and income situation, household income had continued rising moderately, reflecting improvements in employment and wages. The gradual increase in household income was likely to continue, given that firms had begun to perceive their holdings of labor as insufficient and corporate profits were expected to remain high.

Private consumption had been steady, although readings varied somewhat among indicators. The number of new passenger-car registrations had been weak, while sales of electrical appliances had continued their steady increase. Sales at department stores had also been firm. As for services consumption, sales in the food service industry had continued to be steady. Outlays for travel, on the other hand, had been almost flat on average. Indicators for consumer sentiment had been improving. As for the outlook, private consumption was likely to continue recovering steadily against the background of a gradual increase in household income.

Domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen in the second half of 2005. They were expected to continue increasing for the time being, mainly due to the effects of the rise in international commodity prices. The year-on-year rate of change in consumer prices (excluding fresh food, on a nationwide basis) had turned slightly positive (0.1 percent) in November 2005. As for the outlook, a positive trend was projected to be established in the year-on-year change in consumer prices, as supply-demand conditions continued improving gradually and the effects from the reduction in telephone charges dissipated.

Reports at the meeting of general managers of the Bank's branches and the *Regional Economic Report* released on January 13, 2006 confirmed that the economic recovery was spreading to many regions of the country, although disparities remained in the degree of improvement.

2. Financial environment

The environment for corporate finance was becoming more accommodative on the whole. The lending attitude of private banks was becoming more accommodative, and that of financial institutions as perceived by firms had also been improving. The pace of decline in credit demand in the private sector had been becoming very moderate. Under these circumstances, the rate of increase in the amount outstanding of lending by private banks was accelerating, and the amount outstanding of CP and corporate bonds issued had been above the previous year's level.

The year-on-year growth rate of the monetary base was at the 1.0–2.0 percent level, and that of the money stock (M_2+CDs) had been around 2.0 percent.

II. Summary of Discussions by the Policy Board on Economic and Financial Developments

A. Economic Developments

On the current state of Japan's economy, members agreed that it continued to recover steadily, with both domestic and external demand continuing to increase.

Members agreed that overseas economies, particularly those of the United States and East Asia, continued to expand, and were likely to keep expanding.

On the U.S. economy, many members said that it continued to expand steadily, led mainly by household spending and business fixed investment, and was likely to keep expanding at a pace around its potential growth rate. A few members commented on private consumption that Christmas sales seemed to have shown somewhat higher growth than in 2004. Some members said that the yield curve had become almost flat, and in financial markets expectations that the Federal Reserve would stop raising the interest rate in the near future were increasing. In relation to this, one member commented that concern over inflation persisted, given that the rate of utilization of resources, including the labor force and production facilities, remained at a high level and international commodity prices continued to rise.

One member expressed the view that the growth rate of the U.S. economy for the October–December quarter of 2005 was likely to show a slight deceleration, citing a slowing in production of motor vehicles and related goods and a deceleration in growth in housing investment. The member added that as developments in housing prices would affect private consumption, for example, through wealth effects, they should be watched carefully together with developments in long-term interest rates.

With regard to East Asian economies, members agreed that both domestic and external demand continued to expand strongly in China. One member said that although the Chinese economy had so far been expanding steadily, attention still needed to be paid to developments concerning reforms of the renminbi exchange rate regime and the effects on the economy of excess production capacity.

Some members commented on risk factors for the global economy that crude oil prices had recently started to rise again against the background of concerns over geopolitical risks and tightening of the supply and demand situation. They said that how this affected inflation expectations and economic activity continued to warrant close attention.

Regarding Japan's economy, members agreed that exports had continued to increase, reflecting the expansion of overseas economies, and were likely to continue to rise. One member said that exports to China, which had been lacking in momentum until the middle of 2005, continued to post a solid increase in the October–November period after having risen notably in the summer. The member continued that an uptrend in exports to China was becoming clear.

As for domestic private demand, members agreed that both business fixed investment and private consumption had been increasing steadily, as positive developments in the corporate sector had been spreading to the household sector.

With regard to developments in the corporate sector, members agreed that business fixed investment had continued to increase and was likely to keep increasing, since the perception among firms of having excess production capacity had generally dissipated and corporate profits remained high. One member said that firms had so far implemented business fixed investment mainly for the purpose of maintenance and repair. Recently, however, there was a new movement spreading among firms to make business fixed investment to expand production capacity, albeit still cautiously. The member expressed the view that this was because, as corporate management had started to emphasize increasing profits in the medium to long term as a management goal, they were becoming concerned that a lack of proactive investment would impair future competitiveness.

As for the employment and income situation, members agreed that the number of employees and wages had been increasing, and household income had continued to rise moderately. One member said that people's incentive to seek jobs was increasing as the employment situation was improving, and it was becoming clear that the decline in the labor force participation rate was coming to a halt. Some members pointed out that the year-on-year growth rate of winter bonus payments by large firms seemed to have exceeded that of summer bonus payments, according to survey results and other sources. A few members referred to the possibility of wage increases being agreed in negotiations in spring 2006, particularly at firms with strong business performance, and said that if such movements became widespread, positive effects of corporate profits on household income would increase further.

Members agreed that private consumption had been steady, and it was likely to continue to expand steadily against the background of the improvement in the employment and income situation. Some members pointed out that, although the number of new passenger-car registrations had been somewhat weak, sales of electrical appliances were good and sales at department stores in late December to early January were favorable, particularly those of luxury goods, such as jewelry. One member expressed the view that the actual state of private consumption might be stronger than suggested by various economic indicators that the Bank was monitoring, since the statistical coverage of outlays for services was relatively limited. A different member pointed out that the personal saving rate for fiscal 2004 declined to 2.8 percent and dividend income exceeded interest income, and said that these developments might be supporting the steadiness in private consumption. Another member commented that the steadiness in private consumption was also attributable to the increase in consumer sentiment against the background of such factors as wealth effects from the rise in stock prices.

Members agreed that an uptrend in production had become evident, in a situation where demand both at home and abroad had been increasing steadily. A few members pointed out that industrial production was increasing for the fourth consecutive month, particularly in IT-related sectors, and said that recovery in production, which had been lagging behind the recovery in the demand side, had become clear. These members added that production was likely to increase further, judging from anecdotal information and other factors. One member said, however, that attention should be paid to the continuing adjustments in inventories in materials industries.

On prices, members agreed that domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen in the second half of 2005, and said that they were expected to continue increasing. They continued that the year-on-year rate of change in consumer prices (excluding fresh food, on a nationwide basis) had turned slightly positive (0.1 percent) in November 2005, and that a positive trend was projected to be established in the year-on-year change in consumer prices, as supply-demand conditions continued improving gradually in line with economic recovery and the effects from the reduction in telephone charges dissipated.

Regarding price developments from a longer-term perspective, some members said that although the year-on-year rate of change in consumer prices might fluctuate in the short term due to temporary factors, a positive trend was likely to be established. This was because the supply-demand balance was likely to improve and downward pressures from unit labor costs were likely to decrease in a situation where wages were increasing. One member commented that people's expectations for prices were changing significantly from those of the last few years, referring to the fact that the Bank's *Opinion Survey on the General Public's Mindset and Behavior* and the Cabinet Office's *Consumer Confidence Survey* suggested that the proportion of the respondents who expected prices to have risen one year from now had reached about 50 percent.

B. Financial Developments

On the financial front, members concurred that the financial environment remained extremely accommodative.

One member noted a rise in the rate of increase in banks' lending, and said that supply-side factors, namely, a more active stance with regard to lending, seemed to have played a considerable role given that lending rates remained on a declining trend. The member added that firms' demand for funds was showing signs of improvement as seen in the continuing increase in business fixed investment and a rise in dividend payments and share buybacks. This member also commented that the environment for corporate finance was becoming more accommodative, since the rate of return on investment had been increasing significantly in line with economic recovery in a situation where firms' funding costs had generally been at low levels. A few other members expressed the view that monetary easing effects were the strongest since the introduction of the quantitative easing policy, judging from the fact that, for example, real interest rates had been declining with the improvement in the price situation and the equilibrium interest rate, the rate which was neutral for the economy, had been rising in line with the economic recovery.

Some members said that stock prices, especially those of stocks listed on emerging stock exchanges, which had been traded actively by individual investors, had recently declined relatively significantly due partly to the effects of alleged violation of the Securities and Exchange Law by certain firms. However, there was no fundamental change in the environment for stock prices, since the economy continued to recover steadily and the situation of corporate profits remained likely to be favorable. A few members commented that the pace of the recent rise in stock prices had seemed too fast, even considering the fact that the rise since the middle of 2005 basically reflected the favorable performance of corporate profits. They continued that the alleged violation of the law had triggered stock price adjustment to some extent. A few other members expressed concern about the risk that the extremely accommodative financial environment might lead to an excessive rise in asset prices. Some members commented that close attention should be paid to developments in stock prices, including the effects of the alleged violation of the law on investors' sentiment and on market participants' confidence in Tokyo stock markets.

C. Interim Assessment

Given the above assessment of economic activity, prices, and financial developments in Japan, members agreed on the following interim assessment in relation to the outlook presented in the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) released in October 2005. First, Japan's economy was expected to deviate slightly above the outlook, as both domestic and external demand continued to increase steadily. Second, domestic corporate goods prices were expected to deviate slightly above the outlook, reflecting the rise in international commodity prices and the depreciation of the yen in the second half of 2005. And third, consumer prices were projected to be broadly in line with the outlook. Some members expressed the view that, although the pace of recovery of Japan's economy was not accelerating, the recovery of Japan's economy was well balanced in terms of the balance between domestic and external demand and between the corporate and the household sector, and the resilience of the economy to shocks was increasing.

Many members said that the effects of developments in crude oil prices, which had recently been rising again, on inflation expectations and long-term interest rates, and in turn on the global economy, particularly the U.S. economy, were risk factors that should be watched closely for the time being. Members agreed that, regarding risk factors that could cause positive and negative deviations, attention should continue to be paid to the three factors mentioned in the October Outlook Report.

III. Summary of Discussions on Monetary Policy for the Immediate Future

On the monetary policy stance for the immediate future, members agreed that it was appropriate to maintain the current framework of the quantitative easing policy in accordance with the Bank's commitment.

A few members expressed the view that it would be appropriate to lower the target range for the outstanding balance of current accounts at the Bank at this point mainly for the following reasons. First, financial institutions' demand for liquidity required for funds management was on a declining trend. And second, the Bank should encourage formation of interest rates based on the market mechanism as much as possible to ensure smooth termination of the quantitative easing policy in the future. Against this view, the majority of members said that it was appropriate to maintain the current guideline for money market operations, including the proviso.

Some members said that market participants were paying greater attention to when the Bank would depart from the present monetary policy framework and to its conduct of monetary policy thereafter, given that the year-on-year rate of change in the consumer price index (CPI) had turned positive. On this point, members agreed that the Bank should thoroughly examine economic activity and prices, and make a judgment on the termination of the quantitative easing policy, without any preconceived idea, according to whether it could be judged that the year-on-year rate of change in the CPI was registering zero percent or higher on a sustainable basis.

Members discussed the Bank's communication of its thinking concerning the conduct of monetary policy after the change of the policy framework. One member said that the Bank's basic thinking was described in the Outlook Report as follows. First, conceptually, the course of monetary policy after the change of the framework would be a period of very low short-term interest rates followed by a gradual adjustment to a level consistent with economic activity and price developments. And second, if it was judged that upward pressure on prices continued to be contained and the economy followed a sustainable and balanced growth path, this was likely to give the Bank latitude in conducting monetary policy through the entire process. The member expressed the view that the Bank should have more in-depth discussions from the viewpoint of examining possible measures to ensure, in the unprecedented situation of termination of the framework of the quantitative easing policy, that financial markets would perform their pricing function smoothly reflecting underlying conditions of the economy and prices. Regarding these points, some members emphasized that a forward-looking approach would be important.

One member commented that under the quantitative easing policy the Bank's commitment based on the CPI had been playing a role as an anchor for economic agents' expectations regarding future developments in prices. The member expressed the view that when shifting to an interest rate policy the Bank should indicate a desirable rate of inflation as a new anchor to replace the current commitment. Against this view, one member said that the Bank should regard indication of a numerical target as an issue to be examined in the medium to long term. This was because Japan's economy was currently at a turning point in a shift from the economic structure which had existed since the second half of the 1990s, in which prices were not sensitive to changes in the output gap. The member continued that, taking into account considerable uncertainty regarding the economic structure, hasty indication of a numerical target for price stability to be achieved in the long term based on imperfect knowledge would not contribute to enhancing the transparency of the conduct of monetary policy. Rather, it might undermine confidence in the Bank's monetary policy. In response to this, the member who had proposed indication of a numerical target argued that the economic structure was always subject to uncertainty, and central banks abroad were taking measures to enhance the transparency of the conduct of monetary policy while facing similar problems. A different member said that for the foreseeable future it was appropriate to seek measures to enhance the transparency of the conduct of monetary policy without indicating a numerical target. This was because at present there was a considerable risk that a framework of inflation targeting would be misunderstood to be one where the Bank ought to make automatic monetary policy responses to changes in the price index, although inflation targeting was basically aimed at achieving the announced inflation target in the medium to long term. Another member commented that the choice of price index would also be a significant issue to be discussed in indicating a numerical target for price stability.

Based on the above discussions, members agreed on the following points regarding the Bank's communication of its thinking after the change of the policy framework. First, the Bank should continue to discuss the matter. And second, it was important for the Bank to keep an appropriate balance between enhancing the transparency of the conduct of monetary policy and ensuring its flexibility and timeliness.

IV. Remarks by Government Representatives

The representative from the Ministry of Finance made the following remarks.

(1) The budget for fiscal 2006 reflected the government's stance of firmly maintaining and strengthening its commitment to the fiscal restructuring policy. The government considered that it would enable it to make further progress in improving the fiscal position and provide a basis for discussions about reform of both expenditure and revenue in an integrated manner. Specifically, it contained general expenditures below the level of the previous fiscal year's budget for the second consecutive year, reflecting the ongoing progress of various reforms, such as the reform of the medical care insurance system, the reform package relating to three issues (reform of state subsidies, transfer of tax resources from the central to local governments, and reform of local allocation tax), and reduction in total personnel costs for civil servants. On the revenue side, the across-the-board income tax credit would be ended, given the improvement in the economic situation. As a result of these efforts with regard to both revenue and expenditure, planned issuance of new financial resource bonds had fallen below 30 trillion yen and the primary balance of the general account would improve for the third consecutive year.

(2) Regarding the economic outlook for fiscal 2006, the government considered that the likelihood of overcoming deflation would increase in fiscal 2006 as Japan's economy was likely to continue to recover at a moderate pace.

(3) However, this was based on the premise that policy efforts were made together with the Bank, and the utmost efforts continued to be required in overcoming deflation. The government would therefore like the Bank in its conduct of monetary policy to firmly continue efforts to overcome deflation, carrying out a careful and comprehensive assessment of economic activity and prices and closely monitoring developments in financial markets and overall interest rates. The government would also like the Bank to carefully explain its thinking concerning its monetary policy to market participants and the public in order to prevent financial markets from becoming unstable due to speculation regarding the future conduct of monetary policy.

The representative from the Cabinet Office made the following remarks.

(1) Japan's economy was recovering at a moderate pace. However, deflation persisted and overcoming it continued to be an important policy task the government should tackle together with the Bank.

(2) The Cabinet decided the text of "Fiscal 2006 Economic Outlook and Basic Stance for Economic and Fiscal Management" and "Structural Reform and Medium-Term Economic and Fiscal Perspectives—FY 2005 Revision" on January 20, 2006. The government considered that achieving a stable inflation rate that would be compatible with sustainable economic growth led mainly by private demand should be the foundation for the conduct of macroeconomic policy and fiscal management for the medium term. The government expected that in fiscal 2006 the likelihood of overcoming deflation would increase through policy efforts together with the Bank.

(3) In order to judge whether the economy had overcome deflation, not only the CPI but also various other price indicators, such as the GDP deflator, should be monitored. The judgment should be made carefully based on a comprehensive review of the underlying trend of prices that excluded the effects of the surge in crude oil prices and other special factors, and of the background of price formation, such as developments in the output gap.

(4) The government hoped that the Bank would implement effective monetary policy that would be consistent with the government's outlook for the economy, taking into account the importance of overcoming deflation. Furthermore, the government would like the Bank to consider presenting

a desirable price level and the future path, including the Bank's thinking about the course in reaching that level, in order to promote proper formation of expectations in financial markets, and thereby contribute to sustainable economic growth with price stability and the overcoming of deflation.

V. Votes

Based on the above discussions, the majority of members agreed that it was appropriate to maintain the current guideline, including the proviso, for money market operations with the target for the outstanding balance of current accounts at the Bank at around 30 to 35 trillion yen.

Two members, however, said that they would like to propose that the Bank should lower the target for the outstanding balance of current accounts at the Bank from "around 30 to 35 trillion yen" to "around 27 to 32 trillion yen."

As a result, the following proposal was submitted and put to the vote.

Mr. T. Fukuma and Mr. A. Mizuno proposed the following guideline for money market operations for the intermeeting period ahead:

> The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 27 to 32 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. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

The proposal was defeated by majority vote.

Votes for the proposal: Mr. T. Fukuma and Mr. A. Mizuno.
Votes against the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, and Mr. K. G. Nishimura.

To reflect the majority view, the chairman formulated the following proposal.

The Chairman's Policy Proposal on the Guideline for Market Operations:
The guideline for money market operations for the intermeeting period ahead will be as follows, and will be made public by the attached statement (see Attachment).

> 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. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, and Mr. K. G. Nishimura.
Votes against the proposal: Mr. T. Fukuma and Mr. A. Mizuno.

Mr. T. Fukuma dissented from the above proposal, arguing that the Bank should lower the target range for the outstanding balance of current accounts at the Bank gradually in a step-by-step manner, while carefully examining economic and financial developments, as long as the maintenance of the current framework of the quantitative easing policy would not be hindered, for the following four reasons. First, the Bank should encourage formation of interest rates based on the market mechanism as much as possible to restore the proper functioning of the market. Second, the Bank should shorten maturities of funds-supplying operations to enhance the timeliness and flexibility of its conduct of monetary policy. Third, it would take a considerable time for the effects of monetary policy to materialize in the economy. And fourth, it was possible to support sustainable economic recovery with price stability by maintaining the zero interest rate environment based on the Bank's commitment in terms of policy duration.

Mr. A. Mizuno dissented from the proposal for the following reasons. First, to ensure financial market stability in the period around the termination of the quantitative easing policy, it would be appropriate to start lowering the outstanding balance in line with developments in the market, rather than lowering it intensively over a short period of time. Second, to minimize the possible shocks from the termination of the policy, the Bank should create an environment where it could communicate with market participants via interest rates. Third, lowering the target range for the outstanding balance of current accounts at an early stage would enable the Bank to proceed more smoothly with the normalization of its monetary policy after the termination of the quantitative easing policy. And fourth, lowering the target range could be expected to have an announcement effect that the Bank was taking into consideration the risk of asset inflation.

VI. Discussion on the Bank's View of Recent Economic and Financial Developments

Members discussed "The Bank's View" in the *Monthly Report of Recent Economic and Financial Developments* (consisting of "The Bank's View" and "The Background"), and put it to the vote.

The Policy Board decided, by unanimous vote, the text of "The Bank's View." It was confirmed that "The Bank's View" would be published on January 20, 2006 and the whole report on January 23, 2006.[7]

VII. Approval of the Minutes of the Monetary Policy Meeting

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of December 15 and 16, 2005 for release on January 25, 2006.

Attachment

January 20, 2006
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by 7–2 majority vote, to set the following guideline for money market operations for the intermeeting period:

> 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. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

7. The English version of the whole report was published on January 24, 2006.

THE BANK'S VIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS[8]

Japan's economy continues to recover steadily.

Exports have continued to increase, and the uptrend in industrial production has become evident. Business fixed investment has continued to increase against the background of high corporate profits. Household income has also continued rising moderately, reflecting the improvement in employment and wages. In this situation, private consumption has been steady. Housing investment has continued to show some strength. Meanwhile, public investment has basically been on a downtrend.

Japan's economy is expected to continue to recover steadily.

Exports are expected to continue rising against the background of the expansion of overseas economies. Domestic private demand is likely to continue increasing against the background of high corporate profits and the moderate rise in household income, while structural adjustment pressure, such as the excess debt of firms, has almost dissipated. In light of these increases in demand both at home and abroad, production is also expected to follow an increasing trend. Public investment, meanwhile, is projected to remain on a downtrend.

On the price front, domestic corporate goods prices have continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen in the second half of last year. The year-on-year rate of change in consumer prices (excluding fresh food) has turned slightly positive.

Domestic corporate goods prices are expected to continue increasing for the time being, mainly due to the effects of the rise in international commodity prices. As for the year-on-year rate of change in consumer prices, a positive trend is projected to be established, as supply-demand conditions continue improving gradually and the effects from the reduction in telephone charges dissipate.

As for the financial environment, the environment for corporate finance is becoming more accommodative on the whole. The issuing environment for CP and corporate bonds is favorable. Also, the lending attitude of private banks is becoming more accommodative. The lending attitude of financial institutions as perceived by firms has been improving. The pace of decline in credit demand in the private sector is very moderate. Under these circumstances, the rate of increase in the amount outstanding of lending by private banks is accelerating, and the amount outstanding of CP and corporate bonds issued has been above the previous year's level. The year-on-year growth rate of the monetary base is 1.0 percent, and that of the money stock has been around 2.0 percent. As for developments in financial markets, money market conditions continue to be extremely easy, as the Bank of Japan continues to provide ample liquidity. In the foreign exchange and capital markets, the yen's exchange rate against the U.S. dollar and long-term interest rates have been around the same level as last month. Meanwhile, stock prices rose significantly through mid-January, and later fell. They are currently above the level of last month.

Japan's economy is expected to deviate slightly above the outlook presented in the *Outlook for Economic Activity and Prices* (the Outlook Report) released in October last year, as both domestic and external demand continue to increase steadily. As for prices, domestic corporate goods prices are expected to deviate slightly above the outlook, reflecting the rise in international commodity prices and the depreciation of the yen in the second half of last year. Meanwhile, consumer prices are projected to be broadly in line with the outlook.

8. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on January 19 and 20, 2006. It is based on information available at the time of the meeting.

Publications of the Monetary Policy Meeting on February 8 and 9, 2006

Minutes

Released on March 14, 2006

The Bank's View of Recent Economic and Financial Developments

Released on February 9, 2006

English translations prepared by the Bank's staff based on the Japanese originals

MINUTES OF THE MONETARY POLICY MEETING ON FEBRUARY 8 AND 9, 2006

A Monetary Policy Meeting of the Bank of Japan Policy Board was held in the Head Office of the Bank of Japan in Tokyo on Wednesday, February 8, 2006, from 2:00 p.m. to 3:37 p.m., and on Thursday, February 9, from 9:00 a.m. to 12:14 p.m.[1]

Policy Board Members Present

Mr. T. Fukui, Chairman, Governor of the Bank of Japan
Mr. T. Muto, Deputy Governor of the Bank of Japan
Mr. K. Iwata, Deputy Governor of the Bank of Japan
Ms. M. Suda
Mr. S. Nakahara
Mr. H. Haru
Mr. T. Fukuma
Mr. A. Mizuno
Mr. K. G. Nishimura

Government Representatives Present

Mr. K. Akaba, Senior Vice Minister of Finance, Ministry of Finance[2]
Mr. K. Sugimoto, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance[3]
Mr. Y. Nakajo, Vice Minister for Policy Coordination, Cabinet Office

Reporting Staff

Mr. E. Hirano, Executive Director (Assistant Governor)
Mr. M. Shirakawa, Executive Director
Mr. A. Yamamoto, Executive Director
Mr. H. Yamaguchi, Director-General, Monetary Affairs Department
Mr. S. Uchida, Senior Economist, Monetary Affairs Department
Mr. H. Nakaso, Director-General, Financial Markets Department
Mr. H. Hayakawa, Director-General, Research and Statistics Department
Mr. K. Momma, Deputy Director-General, Research and Statistics Department
Mr. A. Horii, Director-General, International Department

Secretariat of the Monetary Policy Meeting

Mr. Y. Nakayama, Director-General, Secretariat of the Policy Board
Mr. T. Kozu, Adviser to the Governor, Secretariat of the Policy Board
Mr. K. Murakami, Director, Secretariat of the Policy Board
Mr. S. Shiratsuka, Senior Economist, Monetary Affairs Department
Mr. T. Kato, Senior Economist, Monetary Affairs Department

I. Summary of Staff Reports on Economic and Financial Developments[4]

A. Money Market Operations in the Intermeeting Period

The Bank conducted market operations in accordance with the guideline decided at the previous meeting on January 19 and 20, 2006.[5] The outstanding balance of current accounts at the Bank moved in the 31–35 trillion yen range.

B. Recent Developments in Financial Markets

The weighted average of the uncollateralized overnight call rate was at around zero percent. Interest rates on term instruments were generally stable at low levels.

Japanese stock prices rose reflecting announcements of business performance by some firms and increased expectations of economic recovery. The Nikkei 225 Stock Average was recently moving in the range of 16,500–17,000 yen.

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1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on March 8 and 9, 2006 as "a document which contains an outline of the discussion at the meeting" stipulated in Article 20, Paragraph 1 of the Bank of Japan Law of 1997. Those present are referred to by their titles at the time of the meeting.
2. Mr. K. Akaba was present on February 9.
3. Mr. K. Sugimoto was present on February 8.
4. Reports were made based on information available at the time of the meeting.
5. The guideline was as follows:

> 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. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

Long-term interest rates rose reflecting such factors as a rise in U.S. interest rates and strong Japanese economic indicators. They were moving in the range of 1.55–1.60 percent recently.

The yen depreciated against the U.S. dollar partly because the dollar was purchased by foreign investors in view of generally firm U.S. economic indicators. It was recently being traded in the range of 117–119 yen to the dollar.

C. Overseas Economic and Financial Developments

The U.S. economy continued to expand steadily, at a pace around its potential growth rate, led mainly by household spending and business fixed investment. Although prices had recorded a high increase temporarily due to the elevated energy prices, the inflation rate was increasing moderately in terms of the basic trend.

In the euro area, although the economy remained somewhat sluggish, the momentum for recovery had been gradually increasing as evidenced by the pickup in exports and production partly due to depreciation of the euro.

With regard to East Asian economies, in China both domestic and external demand continued to expand strongly. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole, although negative effects of high energy prices could be seen in some economic activity.

In U.S. and European financial markets, long-term interest rates rose, partly reflecting the release of stronger-than-expected economic indicators. Stock prices in the United States fluctuated somewhat, while those in Europe increased. In financial markets in most of the emerging economies, their currencies and stock prices rose and yield differentials between their sovereign bonds and U.S. Treasuries narrowed.

D. Economic and Financial Developments in Japan

1. Economic developments

Exports had continued to increase against the background of the expansion of overseas economies. Exports to the United States had continued to increase steadily, posting a sizeable gain in the October–December quarter, led by automobile-related goods. Those to China, which had been lacking in momentum until the middle of 2005, posted a solid increase in the October–December quarter, particularly in IT-related goods and automobile-related goods, after having risen notably in the July–September quarter. Exports were expected to continue rising, against the background of the further expansion of overseas economies, especially in the United States and East Asia.

In the corporate sector, business fixed investment had continued to increase, and was expected to keep increasing, since the expansion in domestic and external demand and the high level of corporate profits were likely to be maintained.

As for the employment and income situation in the household sector, household income had continued rising moderately, reflecting improvements in employment and wages, as various indicators for labor market conditions had been improving. The gradual increase in household income was likely to continue, given that firms had begun to perceive their holdings of labor as insufficient and corporate profits were expected to remain high.

Private consumption had been steady overall, although readings still varied among indicators. The number of new passenger-car registrations bounced back in January led mainly by small passenger cars, after showing weak developments since the second half of 2005. Sales of electrical appliances had continued their steady increase, and sales at department stores had remained firm. Outlays for travel, on the other hand, had been almost flat on average. Indicators for consumer sentiment had been on an improving trend. As for the outlook, private consumption was likely to continue recovering steadily, partly against the background of a gradual increase in household income.

Production had continued to increase since early autumn, although it had repeatedly exhibited fluctuations due to statistical factors until the middle of 2005. Figures for the October–December quarter by industry showed that production of electronic parts and devices posted brisk gains and that of general machinery and transport machinery also stepped up. Production was expected to continue its uptrend, as overseas economies would continue to grow and the foundation for a recovery in domestic demand was solid.

Inventories overall had been more or less in balance with shipments, although they had been relatively high in, for example, some materials industries.

Domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen in the second half of 2005. They were expected to continue increasing for the time being, mainly due to the effects of the rise in international commodity prices. The year-on-year rate of change in consumer prices (excluding fresh food, on a nationwide basis) had been slightly positive in November and December, 0.1 percent in both months, after recording 0.0 percent in October. As for the outlook, a positive trend was projected to be established in the year-on-year change in consumer prices, as supply-demand conditions continued improving gradually and the effects from the reduction in telephone charges dissipated.

2. Financial environment

The environment for corporate finance was becoming more accommodative on the whole. The lending attitude of private banks was becoming more accommodative, and that of financial institutions as perceived by firms had also been improving. The decline in credit demand in the private sector was coming to a halt. Under these circumstances, the rate of increase in the amount outstanding of lending by private banks was accelerating, and the amount outstanding of CP and corporate bonds issued had been above the previous year's level.

The year-on-year growth rate of the monetary base had been at the 1.0–2.0 percent level, and that of the money stock (M_2+CDs) had been around 2.0 percent.

II. Summary of Discussions by the Policy Board on Economic and Financial Developments

A. Economic Developments

On the current state of Japan's economy, members agreed that it continued to recover steadily. Many members said that there continued to be a well-balanced economic recovery, particularly in terms of the balance between domestic and external demand and between the corporate and the household sector, and that this was expected to continue.

Members agreed that overseas economies, particularly those of the United States and East Asia, continued to expand, and were likely to keep expanding.

On the U.S. economy, many members expressed the view that it continued to expand steadily, led mainly by household spending and business fixed investment, and was likely to keep expanding at a pace around its potential growth rate. Some members commented on the real GDP growth rate for the October–December quarter which turned out to be relatively low, 1.1 percent on an annualized quarter-on-quarter basis. They noted that this was partly attributable to temporary factors, such as a fall in private consumption, caused by a decrease in sales of motor vehicles as a reaction to their high growth in the July–September quarter, and an increase in imports of energy due to hurricane-related disruptions, as well as to the lower-than-expected increase in inventories. They judged that, given the recent developments in demand and the ongoing improvement in the employment situation, the momentum for economic expansion remained intact. Some members added that careful attention should be paid to developments in housing investment in assessing the pace of U.S. economic expansion.

Some members commented on price developments in the United States that the core consumer price index (CPI), which excluded food and energy prices, had been rising moderately partly against the background of an improvement in supply-demand conditions and an increase in unit labor costs due to a decline in labor productivity. A few members referred to the fact that, given these developments in economic activity and prices, the Federal Open Market Committee (FOMC) raised the federal funds rate target by 25 basis points at the January meeting. They expressed the view that there was a growing perception among market participants that the federal funds rate was approaching close to a neutral level, and therefore the future conduct of monetary policy by the Federal Reserve warranted attention. A different member said that uncertainty about the future conduct of monetary policy was spreading among market participants, in part since there were concerns about inflation and at the same time about a possible deceleration in housing investment.

With regard to East Asian economies, members agreed that both domestic and external demand continued to expand strongly in China, and the NIEs and ASEAN economies continued to expand at a moderate pace on the whole. A few members said that in the euro area the momentum for recovery had been gradually increasing particularly in the corporate sector, as evidenced by the pickup in exports and production due to depreciation of the euro.

Some members commented on risk factors for the global economy that the rise in international commodity prices, particularly crude oil prices, and a possible concomitant heightening of inflation expectations continued to require attention. One member added that the issue of global imbalances continued to warrant careful attention as a medium- to long-term risk.

Regarding Japan's economy, members agreed that exports had continued to increase, reflecting the expansion of overseas economies, and were likely to continue to rise. Some members said that exports to China, which had been lacking in momentum until the middle of 2005, posted a solid increase in the October–December quarter, after having risen notably in the summer, and thus an uptrend in exports to China had become clear. One member noted that the yen had depreciated to its lowest level since 1985 in terms of the real effective exchange rate and this was also expected to support the uptrend in exports.

As for domestic private demand, members concurred that a virtuous cycle was operating where positive developments in the corporate sector spread to the household sector which in turn fed back to the corporate sector through an increase in private consumption. This confirmed that the economic recovery was increasingly becoming self-sustained led by expansion of domestic demand.

With regard to developments in the corporate sector, members agreed that business fixed investment had continued to increase regardless of industry or size of firm and was likely to keep increasing, since the perception among firms of having excess production capacity had dissipated and corporate profits remained high. One member commented that corporate profits had previously increased due mainly to the effects of corporate restructuring while sales had decreased, but in recent years many of the firms whose profits had increased had experienced a rise in sales, suggesting that corporate activity was becoming brisk.

As for the employment and income situation, members agreed that the number of employees and wages had been increasing, and household income had continued to rise moderately, in a situation where labor market conditions had continued to improve and firms had started to perceive their holdings of labor as insufficient, as evidenced by, for example, the ratio of job offers to applicants reaching the 1.00 level for the first time in 13 years. Some members noted that the year-on-year growth rate of winter bonus payments was close to that of summer and winter bonuses in the previous year, and regular payments, driven by the increase in payments to full-time employees, had been increasing gradually. They expressed the view that, if such movements became widespread, positive effects of corporate profits on household income would increase further.

Members expressed the view that private consumption had been steady. They concurred that it was likely to continue to recover steadily since the employment and income situation had continued to improve and indicators for consumer sentiment had been on an improving trend. One member expressed the view that the steady developments in private consumption were due partly to the wealth effect. A different member added that developments in sales of automobiles and factors such as the effects of a future increase in household burden required close monitoring.

Members agreed that production had continued to increase, as demand both at home and abroad had been increasing steadily and was likely to increase further, judging from the production forecast index, anecdotal information, and other factors. Many members added that recovery in production, which had been lagging behind the recovery in the demand side partly due to the effects of temporary factors, had become clear, particularly in the production of electronic parts and devices and transport machinery. Some members noted that shipments were also showing relatively high growth, and expressed the view that inventories in the industrial sector as a whole were more or less in balance with shipments, as could be seen in the inventory cycle where electronic parts and devices were in a recovery phase, although materials industries were in a moderate adjustment phase.

Some members said that future developments in production in IT-related sectors required close monitoring, pointing to facts such as that in the United States the pace of increase in hours worked in IT-related sectors had been slowing and the book-to-bill ratio, the ratio of orders to shipments, of semiconductor manufacturing equipment in North America remained below one.

With regard to prices, many members commented on international commodity prices that crude oil prices remained at high levels due mainly to geopolitical risks, and prices of other commodities such as nonferrous metals continued to increase.

One member added that there was a possibility that the surge in international commodity prices was due in part to excessive liquidity in the global economy. Members agreed that domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen in the second half of 2005, and said that they were expected to continue increasing.

Many members commented that the year-on-year rate of change in consumer prices (excluding fresh food, on a nationwide basis) had been slightly positive in November and December, 0.1 percent in both months, after recording 0.0 percent in October. Some members pointed out that the year-on-year rate of change in consumer prices, excluding special factors such as petroleum product prices and electricity and telephone charges, was around zero percent at present. A different member said that some firms were starting to pass through part of their costs in final goods prices, and this might become more widespread if consumers' expected inflation rate increased.

Members commented on price developments for the January–March quarter of 2006 that since the year-on-year rate of change in consumer prices (excluding fresh food) in the Tokyo metropolitan area was 0.1 percent in January, consumer prices were likely to record a clear year-on-year increase on a nationwide basis in January. They agreed that this would continue for the rest of the quarter as supply-demand conditions continued improving gradually and the effects from the reduction in telephone charges dissipated. Some members commented on price developments thereafter that although the year-on-year rate of change in consumer prices might fluctuate in the short term due to temporary factors, a positive trend was likely to be established. This was because the supply-demand balance was likely to improve and downward pressures from unit labor costs were likely to decrease in a situation where wages were increasing. Some members noted that services prices, which had been declining, had started to increase gradually, and added that whether firms would start to pass the wage increases to prices when they repriced at the beginning of the new fiscal year in April 2006 warranted attention. A different member projected that electricity charges from April were unlikely to be below the previous year's level due partly to the rise in charges calculated based on the fuel cost adjustment system.

With regard to developments in the real estate market, one member said that prices of both land and condominiums were rising in some areas although the rise was not widespread, and future developments required close monitoring.

B. Financial Developments

On the financial front, members concurred that the financial environment remained extremely accommodative.

Some members pointed out that lending by private banks continued to be on an improving trend with the accelerating pace of increase. One of these members said that firms' fund-raising environment was improving in terms of both quantity and interest rates, given that banks' lending attitude was becoming more active and lending rates were on a declining trend. In this situation, funds raised by the private sector had almost recovered to the previous year's level, and the decline in credit demand in the private sector was coming to a halt.

Some members noted that stock prices had returned to the 16,000–17,000 yen level, after a temporary decline due to the effects of alleged violation of the Securities and Exchange Law by certain firms. They expressed the view that this confirmed that market participants considered that the fundamental environment surrounding stock prices, namely, high corporate profits and steady economic recovery, remained unchanged.

A few members noted that long-term interest rates were higher than at the previous meeting due partly to the rise in U.S. long-term interest rates, in addition to the recovery of Japan's economy. One member added that volatility was increasing for interest rates with relatively short-term maturities.

III. Summary of Discussions on Monetary Policy for the Immediate Future

On the monetary policy stance for the immediate future, members agreed that it was appropriate to maintain the current framework of the quantitative easing policy in accordance with the Bank's commitment.

Members agreed that, although the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) had been at or above zero percent for three consecutive months since October 2005, it was still only slightly positive, and thus it could not be judged that it was registering zero percent or higher on a sustainable basis. It was therefore necessary to continue to monitor carefully developments in the CPI and in the underlying economy. Members confirmed again that the Bank would decide a change of the policy framework appropriately according to the commitment based on the CPI announced in March 2001. Some members said that the Bank's judgment whether the year-on-year change in the CPI was registering zero percent or higher on a sustainable basis would become even more important as the CPI was expected to show a clear year-on-year increase in forthcoming releases.

The majority of members said that it was appropriate to maintain the current guideline for money market operations, including the proviso. Against this view, a few members expressed the view that it would be appropriate to lower the target range for the outstanding balance of current accounts at the Bank at this point mainly for the following reasons. First, continuing the unprecedented monetary easing in a situation where the economic recovery was becoming clearer could cause distortion in the allocation of resources and as a result negatively affect economic activity. And second, the Bank should clearly indicate at this stage its intention to gradually lower the outstanding balance of current accounts at the Bank after the termination of the quantitative easing policy.

Members discussed their thinking on the conduct of monetary policy after the change of the policy framework.

Members confirmed again their basic thinking on the conduct of monetary policy that, if it was judged that upward pressure on prices continued to be contained and the economy followed a sustainable and balanced growth path, the extremely accommodative financial environment was likely to be maintained. One member commented that it was important to promote greater understanding among market participants that there would be continuity in monetary policy given that the accommodative financial environment would continue even after termination of the quantitative easing policy.

Many members said that the Bank should continue to deliberate how it could secure transparency in its conduct of monetary policy after the change of the framework.

On this point, one member said that the Bank could indicate a desirable rate of inflation and its basic thinking regarding the future conduct of monetary policy. A different member expressed the view that, by indicating a rate of inflation at which it was considered that Japan's economy would not fall into deflation again, the Bank could provide an anchor for economic agents' expectations regarding future developments in economic activity and prices and contribute to stable formation of expectations in financial markets. A few members said that inflation targeting was basically aimed at achieving the announced inflation target in the medium to long term and it was considered to be a framework that allowed flexible conduct of monetary policy in accordance with, for example, developments in the economy, but it was doubtful whether these points were fully understood in Japan. One member said that, based on past experience, it was important to be aware that the public's expected rate of inflation was low and they had a strong aversion to inflation. A few other members commented that if the Bank examined the possibility of indicating a desirable rate of inflation in terms of a numerical figure, consideration should be given to such points as whether timeliness and flexibility would be maintained in its conduct of monetary policy.

Based on the above discussions, members agreed that the Bank needed to examine specific ways of securing monetary policy transparency, referring to practices of other central banks. They also concurred that first and most importantly the Bank should explain clearly its assessment of the economic and financial situation and its thinking on the conduct of monetary policy. Second, a forward-looking approach should be taken. And third, an appropriate balance should be kept between transparency and flexibility of the conduct of monetary policy.

IV. Remarks by Government Representatives

The representative from the Ministry of Finance made the following remarks.

(1) Japan's economy was showing progress toward overcoming deflation as evidenced by the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) for December released on January 27, 2006 which was positive, albeit only marginally, as in November. However, deflation, albeit moderate, persisted, based on a comprehensive review of the underlying trend of prices that included other price indicators,

such as the GDP deflator, and of the background of the trend.

(2) Ensuring the sustainability of the economic recovery and overcoming deflation were the most important policy tasks the government should tackle together with the Bank. To ensure the achievement of these policy tasks, the government would like the Bank, in its conduct of monetary policy, to firmly continue efforts to overcome deflation and make a careful judgment based on a comprehensive review of economic activity and prices.

(3) The government would also like the Bank, as a monetary authority, to closely monitor developments in financial markets and overall interest rates, and carefully explain its thinking concerning its monetary policy to market participants and the public in order to prevent financial markets from becoming unstable due to speculation regarding the future conduct of monetary policy.

The representative from the Cabinet Office made the following remarks.

(1) Japan's economy was recovering at a moderate pace. However, deflation persisted and overcoming it continued to be an important policy task the government should tackle together with the Bank.

(2) The government expected that in fiscal 2006 the likelihood of overcoming deflation would increase. In order to judge whether the economy had overcome deflation, not only the CPI but also various other price indicators, such as the GDP deflator, should be monitored. The judgment should be made carefully, based on a comprehensive review of the underlying trend of prices that excluded the effects of the surge in crude oil prices and other special factors, and the background of price formation, such as developments in the output gap. The government also considered that achieving a stable inflation rate that would be compatible with sustainable economic growth led mainly by private demand should be the foundation for the conduct of macroeconomic policy and fiscal management for the medium term.

(3) The government hoped that the Bank would implement effective monetary policy that would be consistent with the government's outlook for the economy, taking into account the importance of overcoming deflation. Furthermore, the government would like the Bank to consider presenting a desirable price level and the future path, including the Bank's thinking about the course in reaching that level, in order to promote proper formation of expectations in financial markets, and thereby contribute to the overcoming of deflation and sustainable economic growth with price stability.

V. Votes

Based on the above discussions, the majority of members agreed that it was appropriate to maintain the current guideline, including the proviso, for money market operations with the target for the outstanding balance of current accounts at the Bank at around 30 to 35 trillion yen.

Two members, however, said that they would like to propose that the Bank should lower the target for the outstanding balance of current accounts at the Bank from "around 30 to 35 trillion yen" to "around 27 to 32 trillion yen."

As a result, the following proposal was submitted and put to the vote.

Mr. T. Fukuma and Mr. A. Mizuno proposed the following guideline for money market operations for the intermeeting period ahead:

> The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 27 to 32 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. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

The proposal was defeated by majority vote.

Votes for the proposal: Mr. T. Fukuma and Mr. A. Mizuno.
Votes against the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, and Mr. K. G. Nishimura.

To reflect the majority view, the chairman formulated the following proposal.

The Chairman's Policy Proposal on the Guideline for Market Operations:

The guideline for money market operations for the intermeeting period ahead will be as follows, and will be made public by the attached statement (see Attachment).

> 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. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

> Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, and Mr. K. G. Nishimura.
>
> Votes against the proposal: Mr. T. Fukuma and Mr. A. Mizuno.

Mr. T. Fukuma dissented from the above proposal, arguing that the Bank should lower the target range for the outstanding balance of current accounts at the Bank gradually in a step-by-step manner, while examining economic and financial developments and financial market conditions, as long as the maintenance of the current framework of the quantitative easing policy would not be hindered, for the following four reasons. First, the Bank should encourage formation of interest rates based on the market mechanism to restore the proper functioning of the market. Second, the Bank should shorten maturities of funds-supplying operations to enhance the timeliness and flexibility of its conduct of monetary policy. Third, it would take a considerable time for the effects of monetary policy to materialize in the economy. And fourth, it was possible to support sustainable economic recovery with price stability by maintaining the zero interest rate environment based on the Bank's commitment in terms of policy duration.

Mr. A. Mizuno dissented from the proposal for the following reasons. First, to ensure financial market stability in the period around the termination of the quantitative easing policy, it would be appropriate to start lowering the outstanding balance in line with developments in the market, rather than lowering it intensively over a short period of time. Second, to minimize the possible shocks from the termination of the policy, the Bank should create an environment where it could communicate with market participants via interest rates. Third, lowering the target range could be expected to indicate that the Bank was taking into consideration the risk of asset inflation. And fourth, by lowering the target range by a relatively small amount, the Bank could indicate clearly its stance that it would gradually lower the target range after the termination of the quantitative easing policy.

VI. Discussion on the Bank's View of Recent Economic and Financial Developments

Members discussed "The Bank's View" in the *Monthly Report of Recent Economic and Financial Developments* (consisting of "The Bank's View" and "The Background"), and put it to the vote.

The Policy Board decided, by unanimous vote, the text of "The Bank's View." It was confirmed that "The Bank's View" would be published on February 9, 2006 and the whole report on February 10, 2006.[6]

6. The English version of the whole report was published on February 13, 2006.

Attachment

February 9, 2006
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by 7–2 majority vote, to set the following guideline for money market operations for the intermeeting period:

> 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. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

THE BANK'S VIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS[7]

Japan's economy continues to recover steadily.

Exports and industrial production have continued to increase. Business fixed investment has continued to increase against the background of high corporate profits. Household income has also continued rising moderately, reflecting the improvement in employment and wages. In this situation, private consumption has been steady. Housing investment has shown some strength. Meanwhile, public investment has been on a downtrend.

Japan's economy is expected to continue to recover steadily.

Exports are expected to continue rising against the background of the expansion of overseas economies. Domestic private demand is likely to continue increasing against the background of high corporate profits and the moderate rise in household income, while structural adjustment pressure, such as the excess debt of firms, has almost dissipated. In light of these increases in demand both at home and abroad, production is also expected to follow an increasing trend. Public investment, meanwhile, is projected to remain on a downtrend.

On the price front, domestic corporate goods prices have continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen in the second half of last year. The year-on-year rate of change in consumer prices (excluding fresh food) has been slightly positive.

Domestic corporate goods prices are expected to continue increasing for the time being, mainly due to the effects of the rise in international commodity prices. As for the year-on-year rate of change in consumer prices, a positive trend is projected to be established, as supply-demand conditions continue improving gradually and the effects from the reduction in telephone charges dissipate.

As for the financial environment, the environment for corporate finance is becoming more accommodative on the whole. The issuing environment for CP and corporate bonds is favorable. Also, the lending attitude of private banks is becoming more accommodative. The lending attitude of financial institutions as perceived by firms has been improving. The decline in credit demand in the private sector is coming to a halt. Under these circumstances, the rate of increase in the amount outstanding of lending by private banks is accelerating, and the amount outstanding of CP and corporate bonds issued has been above the previous year's level. The year-on-year growth rate of the monetary base has been at the 1.0–2.0 percent level, and that of the money stock has been around 2.0 percent. As for developments in financial markets, money market conditions continue to be extremely easy, as the Bank of Japan continues to provide ample liquidity. In the foreign exchange and capital markets, long-term interest rates and stock prices have risen compared with last month, while the yen's exchange rate against the U.S. dollar has fallen compared with last month.

7. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on February 8 and 9, 2006. It is based on information available at the time of the meeting.

Publications of the Monetary Policy Meeting on March 8 and 9, 2006

Minutes

Released on April 14, 2006

The Bank's View of Recent Economic and Financial Developments

Released on March 9, 2006

English translations prepared by the Bank's staff based on the Japanese originals

MINUTES OF THE MONETARY POLICY MEETING ON MARCH 8 AND 9, 2006

A Monetary Policy Meeting of the Bank of Japan Policy Board was held in the Head Office of the Bank of Japan in Tokyo on Wednesday, March 8, 2006, from 2:00 p.m. to 3:50 p.m., and on Thursday, March 9, from 9:00 a.m. to 2:07 p.m.[1]

Policy Board Members Present[2]

Mr. T. Fukui, Chairman, Governor of the Bank of Japan
Mr. T. Muto, Deputy Governor of the Bank of Japan
Mr. K. Iwata, Deputy Governor of the Bank of Japan
Ms. M. Suda
Mr. S. Nakahara
Mr. H. Haru
Mr. A. Mizuno
Mr. K. G. Nishimura

Government Representatives Present

Mr. K. Akaba, Senior Vice Minister of Finance, Ministry of Finance[3]
Mr. K. Sugimoto, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance[4]
Mr. Y. Nakajo, Vice Minister for Policy Coordination, Cabinet Office

Reporting Staff

Mr. E. Hirano, Executive Director (Assistant Governor)
Mr. M. Shirakawa, Executive Director
Mr. A. Yamamoto, Executive Director
Mr. H. Yamaguchi, Executive Director (Director-General, Monetary Affairs Department)
Mr. S. Uchida, Senior Economist, Monetary Affairs Department[5]
Mr. H. Nakaso, Director-General, Financial Markets Department
Mr. H. Hayakawa, Director-General, Research and Statistics Department
Mr. K. Momma, Deputy Director-General, Research and Statistics Department
Mr. A. Horii, Director-General, International Department

Secretariat of the Monetary Policy Meeting

Mr. Y. Nakayama, Director-General, Secretariat of the Policy Board
Mr. T. Kozu, Adviser to the Governor, Secretariat of the Policy Board
Mr. K. Murakami, Director, Secretariat of the Policy Board
Mr. T. Kato, Senior Economist, Monetary Affairs Department[6]
Mr. N. Takeda, Senior Economist, Monetary Affairs Department

I. Summary of Staff Reports on Economic and Financial Developments[7]

A. Money Market Operations in the Intermeeting Period

The Bank conducted money market operations in accordance with the guideline decided at the previous meeting on February 8 and 9, 2006.[8] The outstanding balance of current accounts at the Bank moved in the 30–35 trillion yen range.

B. Recent Developments in Financial Markets

The weighted average of the uncollateralized overnight call rate was at around zero percent. Interest rates on term instruments increased.

1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on April 10 and 11, 2006 as "a document which contains an outline of the discussion at the meeting" stipulated in Article 20, Paragraph 1 of the Bank of Japan Law of 1997. Those present are referred to by their titles at the time of the meeting.
2. A member of the Policy Board, Mr. T. Fukuma, was absent and submitted his opinion in writing via the chairman with respect to matters on the agenda of the meeting, in accordance with Article 4, Paragraph 2 of the Rules concerning Policy Board Meetings.
3. Mr. K. Akaba was present on March 9.
4. Mr. K. Sugimoto was present on March 8.
5. Mr. S. Uchida was present on March 8 for the whole of the session, and on March 9 from 9:00 a.m. to 11:50 a.m. and from 12:00 p.m. to 2:07 p.m.
6. Mr. T. Kato was present on March 8 for the whole of the session, and on March 9 from 9:00 a.m. to 11:50 a.m. and from 12:09 p.m. to 2:07 p.m.
7. Reports were made based on information available at the time of the meeting.
8. The guideline was as follows:

    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. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

Japanese stock prices fell, reflecting market participants' speculation about the future conduct of monetary policy. The Nikkei 225 Stock Average was recently moving in the range of 15,500–16,000 yen.

Long-term interest rates had basically been more or less flat, and were moving in the range of 1.60–1.65 percent recently.

The yen appreciated against the U.S. dollar, as it was purchased against the background of market participants' speculation about the future conduct of monetary policy. It depreciated thereafter as the dollar was purchased by foreign investors, and was recently being traded in the range of 116–118 yen to the dollar.

C. Overseas Economic and Financial Developments

The U.S. economy continued to expand steadily, at a pace around its potential growth rate, led mainly by household spending and business fixed investment.

In the euro area, although the economy remained somewhat sluggish, the momentum for recovery had been gradually increasing as evidenced by the pickup in exports and production partly due to depreciation of the euro.

With regard to East Asian economies, in China both domestic and external demand continued to expand strongly. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole, although negative effects of high energy prices could be seen in some economic activity.

In U.S. and European financial markets, long-term interest rates had been more or less flat. Stock prices in the United States and Europe had generally been firm. In financial markets in many emerging economies, their currencies and stock prices rose and yield differentials between their sovereign bonds and U.S. Treasuries narrowed on the whole.

D. Economic and Financial Developments in Japan

1. Economic developments

Exports had continued to increase against the background of the expansion of overseas economies. Exports to the United States had continued to increase steadily, and had posted a sizable gain recently led by automobile-related goods. Exports to the European Union and the NIEs had also been on a moderate increasing trend. Against the background of the further expansion of overseas economies, especially in the United States and East Asia, exports were expected to continue rising.

In the corporate sector, business fixed investment had continued to increase, and was expected to keep increasing because the expansion in domestic and external demand and the high level of corporate profits were likely to be maintained.

As for the employment and income situation in the household sector, household income had continued rising moderately, reflecting improvements in employment and wages, as various indicators for labor market conditions had been improving. The gradual increase in household income was likely to continue, given that firms had begun to perceive their holdings of labor as insufficient and corporate profits were expected to remain high.

Private consumption had become solid. The number of new passenger-car registrations had been picking up since the beginning of 2006, after showing weak developments in the second half of 2005. Sales of electrical appliances had continued their steady increase, and sales at department stores had remained firm. As for the outlook, private consumption was likely to continue increasing steadily, partly against the background of a gradual increase in household income.

Production had continued to increase against the background of the growth in domestic and external demand. Industrial production rose for the sixth consecutive month in January. Production was expected to continue its uptrend. Inventories had been more or less in balance with shipments.

Domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices. They were expected to continue increasing for the time being, mainly due to the effects of rising international commodity prices. The year-on-year rate of change in the consumer price index (CPI; excluding fresh food, on a nationwide basis), which had been slightly positive in November and December at 0.1 percent in both months, recorded a larger increase of 0.5 percent in January. As for the outlook, the year-on-year rate of change in the CPI was projected to follow a positive trend, albeit with some fluctuations, as supply-demand conditions continued improving gradually.

2. Financial environment

The environment for corporate finance was becoming more accommodative on the whole. The lending attitude of private banks was becoming more accommodative, and that of financial institutions as perceived by firms had also been improving. The decline in credit demand in the private sector was coming to a halt. Under these circumstances, the rate of increase in the amount outstanding of lending by private banks was accelerating, and the amount outstanding of CP and corporate bonds issued had been above the previous year's level.

The year-on-year growth rate of the monetary base was around 2.0 percent, and that of the money stock (M_2+CDs) had been at the 1.0–2.0 percent level.

II. Summary of Discussions by the Policy Board on Economic and Financial Developments

A. Economic Developments

On the current state of Japan's economy, members agreed that it continued to recover steadily. Many members said that the economy was likely to experience a sustained recovery in an environment in which a virtuous cycle of production, income, and expenditure could operate, reflecting the recovery in both domestic and external demand and also in the corporate and household sectors.

Members agreed that overseas economies, particularly those of the United States and East Asia, continued to expand, and were likely to keep expanding.

On the U.S. economy, many members expressed the view that it continued to expand steadily, led mainly by household spending and business fixed investment, and was likely to keep expanding at a pace around its potential growth rate. A few members noted that housing sales were beginning to decelerate.

With regard to East Asian economies, members agreed that both domestic and external demand continued to expand strongly in China, and the NIEs and ASEAN economies continued to expand at a moderate pace on the whole.

Some members commented on risk factors for the global economy that attention should be paid, among other factors, to the rise in international commodity prices, particularly crude oil prices, and a possible concomitant heightening of inflation expectations, and to a possible rise in U.S. long-term interest rates. One member added that possible effects of global imbalances on international financial markets continued to warrant careful attention as a medium- to long-term risk.

Regarding Japan's economy, members agreed that exports had continued to increase, reflecting the expansion of overseas economies, and were likely to continue to rise.

As for domestic private demand, members concurred that business fixed investment had continued to increase against the background of the high level of corporate profits, and private consumption had become solid as positive developments in the corporate sector had been spreading to the household sector.

With regard to developments in the corporate sector, members agreed that business fixed investment had continued to increase, and was likely to keep increasing because the perception among firms of having excess production capacity had dissipated and corporate profits remained high. Some members said that, although business fixed investment, especially by small and medium-sized firms, decreased in the October–December quarter based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*, this was thought to be largely due to temporary fluctuations. They continued that, judging from leading indicators such as machinery orders, business fixed investment could be considered to remain on an uptrend. One member said that future developments in corporate profits should be watched carefully, as there were signs of the break-even point for firms and the share of labor in income distribution starting to rise.

As for the employment and income situation, members agreed that the number of employees and wages had been increasing, and household income had continued to rise moderately, in a situation where labor market conditions had continued to improve and firms had started to perceive their holdings of labor as insufficient, as evidenced by, for example, the ratio of job offers to applicants exceeding 1.00 for the second consecutive month.

Members concurred that private consumption had become solid, and was likely to continue to recover steadily because the employment and income situation had continued to improve and indicators for consumer sentiment had been on an improving trend. Some members pointed out that the number of new passenger-car registrations had been picking up since the beginning of 2006, supported by the introduction of new models, after showing weak developments in the second half of 2005. One member noted that private consumption on a GDP basis had been increasing for the fourth consecutive quarter. A few members said that sales of luxury goods had been favorable, and this might be due to wealth effects mainly stemming from the rise in stock prices.

Members expressed the view that production had continued to increase against the background of the growth in domestic and external demand, and was likely to increase further, judging from the production forecast index and anecdotal information.

A few members said that future developments in production of IT-related goods warranted attention.

With regard to prices, members agreed that domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices, and said that they were expected to continue increasing. A few members commented that crude oil prices remained at high levels due mainly to geopolitical risks, and said that developments in international commodity prices continued to require vigilant monitoring.

Members commented that the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis), which had been slightly positive in November and December 2005 at 0.1 percent in both months after recording 0.0 percent in October, registered a relatively clear increase of 0.5 percent in January 2006. Many members said that the year-on-year rate of change in the CPI, excluding special factors such as petroleum product prices and electricity and telephone charges, also turned positive in January at 0.2 percent. One member pointed out that the year-on-year rate of increase in the CPI (excluding fresh food) in the Tokyo metropolitan area rose in February from January. Another member noted that the trimmed mean of the year-on-year rate of change in the CPI was also positive. A different member added that, in terms of the trimmed mean of the year-on-year rate of change in the CPI by category, an increase in that for services was expanding and a decline in that for goods was narrowing. A few members said that the year-on-year rate of change in many items included in the CPI had begun to show steady upward movement since November 2005.

In relation to future developments in consumer prices, many members said that, against the background of the continuing steady recovery in the economy, the output gap was gradually narrowing and unit labor costs were facing weakening downward pressures as wages had begun to rise amid productivity gains. One member noted that households and firms were shifting up their expectations for inflation. A different member pointed out that the rise in imputed rent included in housing expenses, which had a large weight in the CPI, was becoming more evident, and there were signs of a rise in prices for various goods and services reflecting a tightening of the labor market. The member continued that the rate of decline in the price index for personal computers, which had been considerable due to quality adjustment, was decreasing. Most members agreed that, on the premise that the environment for prices continued to improve, the year-on-year change in the CPI was expected to remain positive, although some fluctuations might be observed in monthly data.

B. Financial Developments

On the financial front, members concurred that the financial environment remained extremely accommodative.

One member said that signs of economic recovery were also becoming more evident on the financial side, noting the following factors. First, the rate of increase in the amount outstanding of lending by private banks (after adjustment for special items) had been accelerating since it turned positive in the summer of 2005. And second, the decline in credit demand in the private sector was coming to a halt as banks' lending attitude became more active.

Some members commented that, although stock prices were recently showing nervous developments in the 15,500–16,000 yen range, the fundamental environment surrounding stock prices, namely, high corporate profits and steady economic recovery, remained unchanged.

Some members noted that long-term interest rates were more or less flat at around 1.6 percent, but interest rates on instruments with short- and medium-term maturities were increasing due partly to market participants' speculation regarding monetary policy. A few members added that market participants had already been factoring in to a great extent the termination of the quantitative easing policy.

III. Summary of Discussions on Monetary Policy for the Immediate Future

A. Guideline for Money Market Operations

Members then discussed the conduct of monetary policy for the immediate future.

Most members' view was that, based on the assessment of economic activity and prices described earlier, it could be judged that the condition laid out in the commitment—the Bank would maintain the quantitative easing policy until the year-on-year change in the CPI (excluding fresh food, on a nationwide basis) registered zero percent or higher on a sustainable basis—which was set when the policy was introduced in March 2001, was fulfilled. Most members agreed that it would therefore be appropriate to terminate the quantitative easing policy and shift the operating target of money market operations to an interest rate, and state in the guideline for money market operations for the intermeeting period that the Bank would encourage the uncollateralized overnight call rate to remain at effectively zero percent. In relation to this, a few members commented that the uncollateralized overnight call rate was likely to move at close to zero percent in general, as the outstanding balance of current accounts at the Bank was exceeding required reserves. However, until the functioning of the money market was fully restored, the rate might temporarily rise somewhat due to remaining frictions in the money market in cases where, for example, the supply-demand balance of funds tightened reflecting concentration of funds settlement or some other factor. They continued that the wording "at effectively zero percent" would therefore be appropriate for the guideline for money market operations for the intermeeting period.

One member said that the Bank should not decide to terminate the quantitative easing policy at this meeting, but should postpone the decision, preferably until the meeting on April 28, when the next *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) would be published, or at least until the meeting on April 10 and 11, mainly for the following reasons. First, judgment of whether the year-on-year change in the CPI would remain positive should be based on more extended and detailed analysis. And second, termination of the quantitative easing policy in the period leading up to the fiscal year-end might pose a risk to the stability of the financial markets.

Against this view, a few members expressed the view that, even if the Bank postponed the decision for a month or two, additional factors relevant to the judgment of fulfillment of the condition laid out in the commitment were unlikely to emerge. A few other members said that the quantitative easing policy was an unprecedented monetary policy, which undermined the flexibility of the conduct of monetary policy and the proper functioning of the market. Therefore, since the condition laid out in the commitment was judged to have been fulfilled, it would be appropriate to shift the operating target of money market operations swiftly to an interest rate.

B. Measures concerning Money Market Operations

Members discussed measures concerning money market operations when the Bank terminated the quantitative easing policy. Many members said that, in the process of reducing the outstanding balance of current accounts at the Bank toward a level in line with required reserves, the Bank should carry out money market operations with due consideration, given that financial institutions had managed liquidity against the backdrop of large amounts of current account balances and extensive funds-supplying operations by the Bank for a prolonged period under the quantitative easing policy. From this viewpoint, many members commented that reduction of the current account balance should be carried out over a period of a few months, based on full consideration of conditions in the short-term money market. Concerning the complementary lending facility, they expressed the view that the loan rate should remain at the current level of 0.1 percent and the temporary waiver of add-on rates for frequent users of the facility, in effect since March 2003, should be maintained. Many members said that the process of reduction of the outstanding balance of current accounts at the Bank should be managed through short-term money market operations, and the outright purchases of long-term interest-bearing Japanese government bonds should be continued at the current amounts and frequency for some time, with due regard for the future condition of the Bank's balance sheet.

C. The Bank's Communication regarding the Conduct of Monetary Policy

Members discussed the Bank's communication regarding its conduct of monetary policy after it terminated the quantitative easing policy.

Many members expressed the view that, after shifting the operating target of money market operations to an interest rate, the Bank would need to introduce a new framework to conduct monetary policy and explain it to the public, while ensuring transparency as well as flexibility of monetary policy.

Many members said that it was therefore important that, as the first step, the Bank review and make public its thinking on price stability, which was an objective of monetary policy. The view was expressed by many members that, in order to improve the predictability of monetary policy, the Bank should present more clearly its basic perspectives in examining economic activity and prices, and prepare an outline of its current view on monetary policy based on examination from those perspectives and disclose it.

Many members said that, as stated in "On Price Stability" in October 2000, the Bank considered that price stability was a state where various economic agents including households and firms could make decisions regarding such economic activities as consumption and investments without being concerned about fluctuations in the general price level. They emphasized that the Bank should aim to realize price stability over the medium to long term and should be forward-looking in its conduct of monetary policy, given the time lag before the effects of monetary policy became apparent. Many members commented that the basic indicator for the evaluation of price developments should be the CPI, which covered goods and services consumed by households, the public at large was accustomed to, and also had an advantage in terms of its timeliness. One member expressed the opinion that the Bank should clarify whether it would base its evaluation of price developments on the core CPI or the headline CPI. Against this view, some members said that from a medium- to long-term perspective there would be basically no point in differentiating between the two types of index because, although the core CPI was designed to exclude factors causing temporary fluctuations, such fluctuations would be averaged out in the medium to long term.

Many members commented that it could be considered that price stability was, conceptually, a state where the change in a price index without measurement bias was zero percent. They continued that, from the viewpoint of preventing a deflationary spiral, allowing a slight year-on-year increase in the CPI as a "safety margin" could be deemed consistent with the conceptual understanding of price stability. Some members said that there seemed to be no significant bias in the Japanese CPI mainly due to the efforts made by Japan's Statistics Bureau. Regarding the "safety margin" which acted as a buffer against the risk of declining prices, one member expressed the view that the necessary margin was not large given the following points. First, downward rigidity of nominal wages seemed to have been decreasing. Second, the potential growth rate was likely to increase. And third, the Japanese financial system had regained stability. A different member said that, although neither measurement bias nor the "safety margin" could be expressed by a single numerical value, it was still important for the Bank to discuss price stability in numerical terms taking such factors into account.

Many members said that the conduct of monetary policy must take account of the possibility that the rate of inflation at which the public perceived price stability might be very low, because Japan's average rate of inflation over the last few decades had been lower than in major overseas economies and the economy had experienced a prolonged period of low inflation since the 1990s.

Based on these discussions, members concurred that the level of inflation rate that the Bank currently understood as price stability from a medium- to long-term viewpoint for its conduct of monetary policy was somewhat lower than in major overseas economies.

Members then discussed whether the Bank should express its understanding of medium- to long-term price stability in the form of a numerical value and release it. One member said that the member would object to releasing such a numerical value unless members shared an understanding that the announced figure represented individual members' numerically expressed understanding of price stability, which they would bear in mind in making decisions regarding the conduct of monetary policy, and was not authorized by the Bank as a target rate of inflation, a reference rate for price stability, or a numerical definition of price stability. The member added that, if the meaning of an announced figure was not properly understood, it could even have an adverse effect on the transparency of the conduct of monetary policy. Some members said that, given that price stability in terms of a numerical value would change with changes in the price formation mechanism, it would be difficult to indicate a single numerical figure representing the consolidated view of the members as a target rate of inflation, a reference rate for price stability, or a numerical definition of price stability in the current situation where the structure of the economy was at a turning point. They continued that, from the viewpoint of ensuring the transparency of the conduct of monetary policy, it was worth disclosing the result of discussions in which individual members expressed their understanding of price stability in numerical terms. Members emphasized that when disclosing a numerical value the Bank should clarify that it would not conduct monetary policy in an automatic manner based on the numerical value. Rather, the Bank would assess economic activity and prices and make decisions regarding the conduct of monetary policy with individual members taking into account the Bank's basic thinking on price stability and their individual understanding of price stability in numerical terms.

Members then exchanged views concerning the level of inflation, including specific numerical levels, that each member currently understood as representing "price stability from a medium- to long-term viewpoint."

A few members said that, taking into consideration the measurement bias and the "safety margin" necessary to prevent a sustained decline in prices, the level of inflation that represented their views on "price stability from a medium- to long-term viewpoint" would be higher than 1 percent but lower than 2 percent. Some members commented that, taking into account the possibility that the rate of inflation at which the public perceived price stability might be very low as well as the measurement bias and the necessary "safety margin," the level should be in a range on both sides of about 1 percent. Some other members said that it was important to bear in mind the fact that Japan's average rate of inflation over the last few decades had been low and consequently the inflation level at which the public perceived price stability seemed to be low. The level should therefore be considered to be below 1 percent but with a certain range of variation. One of these members said that, given the measurement bias of the CPI and the distribution of the public's consumption patterns, the rate of increase in the CPI at which the general public perceived price stability would be in a range centering on slightly below 1 percent. A different member commented that the necessary "safety margin" had been diminishing due, for example, to a decrease in downward rigidity of nominal wages, and the median figure was thought to be positive and close to zero percent.

Based on these discussions, one member said that, in the current situation where the structure of the economy was changing dramatically, there was a range of views among the members in their "understanding of medium- to long-term price stability," reflecting differences in their perception of the measurement bias, the "safety margin," and the inflation rate at which the public perceived price stability, and also in the weight they attached to each factor. However, in terms of the year-on-year change in the CPI, an approximate range between zero and 2 percent would cover the distribution of each member's understanding of medium- to long-term price stability, and seemed to be generally consistent with the members' views. With regard to median figures, the member noted that, except for a part of members having a lower figure, most members' median figures seemed to fall on both sides of 1 percent. The member added that it would be meaningful to disclose an outline of the discussions. A different member agreed that this summing up was appropriate. Some members commented that, as the price formation mechanism would change with structural changes in the economy, price stability in terms of a numerical value might also change accordingly. Therefore, the understanding of medium- to long-term price stability that each member bore in mind in making decisions regarding the conduct of monetary policy should be reviewed annually as a rule.

Many members commented that, as it was vital to examine economic activity and prices in making monetary policy decisions, it would be appropriate for the Bank to clarify its "perspectives" or viewpoints that would be a basis for such examination. A few members said that the Bank would be forward-looking in its future conduct of monetary policy based on comprehensive analysis of economic activity and prices. Given this, it should present the basic points of its comprehensive analysis more systematically.

Many members said that, with regard to the assessment of economic activity and prices one to two years in the future as described in the Outlook Report, it was important for the Bank to examine whether, in the outlook deemed most likely by the Bank, economic activity and prices would follow a path of sustainable growth under price stability.

Many members said that, since the economic projection deemed most likely by the Bank, which was described in the Outlook Report, covered a period of about one to two years, the Bank would need to examine various risks that were most relevant to the conduct of monetary policy, namely, those that might affect economic activity and price developments in the long term, beyond the Outlook Report's projection period, and the risk that developments in economic activity and prices might deviate from the scenario deemed most likely by the Bank. A few members raised the following two specific types of risk as examples. The first was risk factors that might significantly impact economic activity and prices if they materialized, such as high inflation, a speculative bubble, or a deflationary spiral, although the probability of these risks materializing was low. The second was risk factors that might affect economic activity and prices in the medium to long term, for example, the financial environment, asset prices, and the public's expectations of inflation.

Many members said that the Bank should outline its current view on monetary policy, in the light of its deliberations on economic activity and prices from the two perspectives described above, and disclose it periodically in the Outlook Report as a rule.

A few members said that the framework of clarifying the Bank's thinking on price stability, examining economic activity and prices from the two perspectives, and outlining its current view on monetary policy was an innovative and transparent policy scheme which reflected the current situation of Japan's economy.

D. The Bank's Current View on Monetary Policy

Members discussed their current view on monetary policy for the immediate future. One member said that, from the first perspective of examining the price situation one to two years in the future, there was a high probability of realizing sustainable growth with price stability. The member continued that, from the second perspective of examining risks in the longer term, it should be noted that over the medium to long term there was a risk of swings in economic activity as the stimulus from monetary policy was amplified against the backdrop of improving corporate profitability and a turnaround in price developments. Other members agreed with this examination from the two perspectives.

In the light of deliberations from the two perspectives described earlier, a few members commented on the future path of monetary policy that there would be a period in which the overnight call rate was at effectively zero percent, followed by a gradual adjustment in the light of developments in economic activity and prices. In this process, if it was judged that inflationary pressures were restrained as the economy followed a balanced and sustainable growth path, an accommodative monetary environment ensuing from very low interest rates would be maintained for some time. Other members agreed with these members.

IV. Submission of Policy Proposals

Based on the above discussions, the chairman formulated the following three policy proposals to reflect the majority view.

The Chairman's Policy Proposal on the Guideline for Money Market Operations:

1. The operating target of money market operations will be changed from the outstanding balance of current accounts at the Bank to the uncollateralized overnight call rate.

2. The guideline for money market operations for the intermeeting period ahead will be as follows.

   The Bank of Japan will encourage the uncollateralized overnight call rate to remain at effectively zero percent.

3. A public statement will be decided separately.

The Chairman's Policy Proposal on the Release of a Public Statement concerning a Change in the Guideline for Money Market Operations:

The decision concerning a change in the guideline for money market operations will be made public by the attached statement (see Attachment 1).

The Chairman's Policy Proposal on the Release of a Public Statement concerning the Introduction of a New Framework for the Conduct of Monetary Policy:

The decision concerning the introduction of a new framework for the conduct of monetary policy will be made public by the attached statement (see Attachment 2).

V. Remarks by Government Representatives

Following the chairman's proposal to change the guideline for money market operations and to introduce a new framework for the conduct of monetary policy, the representatives from the Ministry of Finance (MOF) and the Cabinet Office requested the chairman to adjourn the meeting because they needed to discuss the government's stance on the proposal and might need to contact the Minister of Finance and the Minister of State for Economic and Fiscal Policy. The chairman approved the request. (The meeting adjourned at 1:17 p.m. and reconvened at 1:46 p.m.)

After the meeting reconvened, the representative from the MOF made the following remarks.

(1) Japan's economy was recovering, as seen in the fact that the first preliminary estimate of real GDP for the October–December quarter of 2005 indicated quarter-on-quarter growth of 1.4 percent. Although moderate deflation persisted, a comprehensive review of the underlying trend of prices suggested that the price situation was improving gradually: for example, the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) was 0.5 percent in January 2006, registering zero percent or higher for the fourth consecutive month. The government considered that it was necessary to ensure that this improvement continued.

(2) The chairman had submitted proposals to terminate the quantitative easing policy and to introduce a new framework for the conduct of monetary policy.

(3) The government would like the Bank to make a decision concerning termination of the quantitative easing policy based on careful consideration of the following points. First, it was necessary for the government together with the Bank to firmly continue policy efforts to overcome deflation. And second, the current situation required that due consideration be given to the stability of the financial markets.

(4) The government considered that, if the Bank decided to terminate the quantitative easing policy at this meeting, it should firmly support the economy from the financial side by maintaining a zero interest rate environment in order to ensure the overcoming of deflation in a situation where there remained disparities in economic conditions among regions in terms of the real economy. Moreover, the government considered it necessary that the Bank conduct monetary policy that would ensure market stability. Specifically, first, after termination of the quantitative easing policy, the Bank should carry out money market operations appropriately to prevent the financial markets from becoming unstable by, for example, carefully lowering the outstanding balance of current accounts at the Bank taking into account developments in the market. Second, the Bank should enhance the transparency of its communication concerning its thinking and the future course of its monetary policy, given that the financial markets could become unstable due to speculation. And third, the Bank should make it clear that it would closely monitor developments in overall interest rates including long-term interest rates, and should continue its outright purchases of long-term Japanese government bonds at the current amounts.

(5) The government would respect the Bank's decision concerning termination of the quantitative easing policy, since the discussions and the policy proposals at this meeting showed that the Bank shared the government's views. The government would like the Bank to support the economy from the financial side responsibly to prevent the economy from weakening again, bearing in mind that ensuring the sustainability of the economic recovery and overcoming deflation were important policy tasks. The government hoped that the Bank would continue to implement appropriate monetary policy consistent with the government's economic policy.

The representative from the Cabinet Office made the following remarks.

(1) The government considered that Japan's economy was recovering as stated in the *Monthly Economic Report* of February 2006, in which it made an upward revision of the assessment of the current state of the economy. However, deflation, albeit moderate, persisted, based on a comprehensive review of the underlying trend of prices. It was therefore vital to achieve the government's goal of overcoming deflation in fiscal 2006, as it had reiterated in such Cabinet statements as "Basic Policies for Economic and Fiscal Management and Structural Reform," "Structural Reform and Medium-Term Economic and Fiscal Perspectives," and "Economic Outlook and Basic Stance for Economic and Fiscal Management."

(2) The government would like to strongly request at this time that the Bank continue its policy efforts to overcome deflation together with the government, taking fully into consideration consistency with the government's basic policy for the economy when it examined termination of the quantitative easing policy. Termination of the quantitative easing policy would mean that the commitment in terms of policy duration would

be lost. The government therefore hoped that the Bank would present a transparent framework of monetary policy that would ensure accountability to the public, making it easier for market participants and the public to form an economic outlook and stabilizing their expectations.

VI. Votes

The following three policy proposals submitted by the chairman were put to the vote: (1) the guideline for money market operations; (2) the release of a public statement concerning a change in the guideline for money market operations; and (3) the release of a public statement concerning the introduction of a new framework for the conduct of monetary policy.

The chairman's policy proposal on the guideline for money market operations was approved by 7–1 majority vote.

Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. H. Haru, Mr. A. Mizuno, and Mr. K. G. Nishimura.
Votes against the proposal: Mr. S. Nakahara.

Mr. S. Nakahara dissented from the proposal for the following reasons, although his view of the economic situation did not differ fundamentally from that of the other members. First, judgment of whether the year-on-year change in the CPI remained positive on a sustainable basis from monthly data of the CPI should be based on more extended analysis. Second, judgment that the year-on-year change in the CPI would not become negative again should be based on a careful analysis and examination as it was in the Outlook Report. Third, it was important to take into consideration the March *Tankan* (Short-Term Economic Survey of Enterprises in Japan) and other indicators that would be released through April in making a decision on termination of the quantitative easing policy. And fourth, termination of the quantitative easing policy in the period leading up to the fiscal year-end, which was a critical time for the financial markets, might pose a risk, while the cost of postponing it until April would be negligible.

The chairman's policy proposal on the release of a public statement concerning a change in the guideline for money market operations was approved, by unanimous vote.

Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, Mr. A. Mizuno, and Mr. K. G. Nishimura.
Votes against the proposal: None.

The chairman's policy proposal on the release of a public statement concerning the introduction of a new framework for the conduct of monetary policy was approved, by unanimous vote.

Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, Mr. A. Mizuno, and Mr. K. G. Nishimura.
Votes against the proposal: None.

The Policy Board approved preparation of the background notes for "The Bank's Thinking on Price Stability" expressed in "The Introduction of a New Framework for the Conduct of Monetary Policy" and their release on March 10, 2006.

Government representatives made the following points in comments after the votes: the government would like the Bank to support the economy from the financial side responsibly, bearing in mind that ensuring the sustainability of the economic recovery and overcoming deflation were important policy tasks; and it would also like the Bank to carefully explain its view on economic activity and prices and its outlook, as well as the relationship between these and the overcoming of deflation, in order to ensure financial market stability. The representatives added that they planned to announce the government's response to the Bank's decision at this meeting later in the day.

VII. Discussion on the Bank's View of Recent Economic and Financial Developments

Members discussed "The Bank's View" in the *Monthly Report of Recent Economic and Financial Developments* (consisting of "The Bank's View" and "The Background"), and put it to the vote.

The Policy Board decided, by unanimous vote, the text of "The Bank's View." It was confirmed that "The Bank's View" would be published on March 9, 2006 and the whole report on March 10, 2006.[9]

9. The English version of the whole report was published on March 13, 2006.

VIII. Approval of the Minutes of the Monetary Policy Meetings

The Policy Board approved unanimously the minutes of the Monetary Policy Meetings of January 19 and 20, 2006 and February 8 and 9 for release on March 14, 2006.

IX. Approval of the Scheduled Dates of the Monetary Policy Meetings in April–September 2006

At the end of the meeting, the Policy Board approved the dates of the Monetary Policy Meetings to be held in the period April–September 2006, for immediate release (see Attachment 3).

Attachment 1

March 9, 2006
Bank of Japan

Change in the Guideline for Money Market Operations

Change in the Guideline for Money Market Operations

At the Monetary Policy Meeting held today, the Bank of Japan decided to change the operating target of money market operations from the outstanding balance of current accounts at the Bank to the uncollateralized overnight call rate, and to set the following guideline for money market operations for the intermeeting period.

> The Bank of Japan will encourage the uncollateralized overnight call rate to remain at effectively zero percent.

Measures concerning Money Market Operations

The outstanding balance of current accounts at the Bank of Japan will be reduced towards a level in line with required reserves. Given that financial institutions have managed liquidity against the backdrop of large amounts of current account balances and extensive funds-supplying operations by the Bank for a prolonged period since the adoption of the quantitative easing policy, the reduction in current account balance is expected to be carried out over a period of a few months, taking full account of conditions in the short-term money market. The process will be managed through short-term money market operations. With respect to the outright purchases of long-term interest-bearing Japanese government bonds, purchases will continue at the current amounts and frequency for some time, with due regard for future conditions of the balance sheet of the Bank. With respect to the complementary lending facility, the loan rate will remain at the current level. The temporary waiver of add-on rates for frequent users of the facility, in effect since March 2003, will also be maintained.

The Bank's View on Economic Activity and Prices

Since March 2001, in view of preventing sustained decline in prices and preparing the basis for sustainable growth, the Bank of Japan has supplied extremely ample liquidity with current account balance at the Bank as the main operating target. The Bank also made a clear commitment to maintain the policy until the consumer price index (excluding fresh food, on a nationwide basis) registers stably zero percent or an increase year on year. The Bank has since maintained the quantitative easing policy according to this commitment.

Currently, Japan's economy continues to recover steadily. Exports have continued to increase reflecting the expansion of overseas economies. With respect to domestic private demand, business fixed investment has also continued to increase against the backdrop of high corporate profits. Robust corporate activity is positively influencing households, and private consumption has become solid. Looking ahead, the Bank expects a sustained recovery.

Concerning prices, year-on-year changes in the consumer price index turned positive. Meanwhile, the output gap is gradually narrowing. Unit labor costs generally face weakening downward pressures as wages began to rise amid productivity gains. Furthermore, firms and households are shifting up their expectations for inflation. In this environment, year-on-year changes in the consumer price index are expected to remain positive. The Bank, therefore, judged that the conditions laid out in the commitment are fulfilled.

Current View on Monetary Policy

Given that the effects of the quantitative easing policy on economic activity and prices now mainly result from short-term interest rates being zero, there will be no abrupt change as a result of today's policy decision.

Looking ahead, in considering the central scenario for economic activity and prices, there is a high probability of realizing sustainable growth under price stability. In the meantime, it should be noted that, over the medium- to long-term, there is a risk of swings in economic activity, as the stimulus from monetary policy is amplified against the backdrop of improving corporate profitability and a positive turn in price developments.

On the future path of monetary policy, there will be a period in which the overnight call rate is at effectively zero percent, followed by a gradual adjustment in the light of developments in economic activity and prices. In this process, if the risk mentioned above remains muted, in other words, if it is judged that inflationary pressures are restrained as the economy follows a balanced and sustainable growth path, an accommodative monetary environment ensuing from very low interest rates will probably be maintained for some time.

March 9, 2006
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by 7–1 majority vote, to set the following guideline for money market operations for the intermeeting period:

> The Bank of Japan will encourage the uncollateralized overnight call rate to remain at effectively zero percent.

Attachment 2

March 9, 2006
Bank of Japan

The Introduction of a New Framework for the Conduct of Monetary Policy

The Bank of Japan Law stipulates the principle of monetary policy as "contributing to the sound development of the national economy" "through the pursuit of price stability." Based on this principle, the Bank is pursuing an appropriate course of monetary policy. At the Monetary Policy Meeting held today, the Bank decided to introduce a new framework for the conduct of monetary policy, as well as to review its thinking on price stability.

1. A New Framework for the Conduct of Monetary Policy

(1) Clarifying Price Stability

The Bank of Japan will review its basic thinking on price stability, and disclose a level of inflation rate that its Policy Board members currently understand as price stability from a medium- to long-term viewpoint, in their conduct of monetary policy ("an understanding of medium- to long-term price stability," see infra). Board members will conduct monetary policy in the light of such thinking and understanding.

(2) Examining Economic Activity and Prices from Two Perspectives

In deciding the conduct of monetary policy, the Bank of Japan will examine economic activity and prices from two perspectives explained below.

The first perspective is examining, as regards economic activity and prices one to two years in the future, whether the outlook deemed most likely by the Bank of Japan follows a path of sustainable growth under price stability.

The second perspective is examining, in a longer term, various risks that are most relevant to the conduct of monetary policy aimed at realizing sustainable growth under price stability. More specifically, for example, the Bank of Japan may examine risk factors that will significantly impact economic activity and prices when they materialize although the probability is low.

(3) Outlining the Current View on Monetary Policy

The Bank of Japan will, in the light of deliberations from the two perspectives described above, outline the current view on monetary policy, and, as a rule, disclose it periodically in the *Outlook for Economic Activity and Prices*.

2. The Bank's Thinking on Price Stability

Price stability is a state where various economic agents including households and firms may make decisions regarding such economic activities as consumption and investments without being concerned about the fluctuations in the general price level.

Price stability is an indispensable prerequisite for realizing sustainable growth, and the Bank of Japan is responsible for realizing price stability through an appropriate conduct of monetary policy. In this regard, given that the effects of monetary policy take time to work through the economy and that volatility of output may actually be amplified when attempts are made to absorb every short-term change in prices resulting from various shocks, the Bank strives to forecast developments in economic activity and prices from a sufficiently long-term viewpoint and to realize price stability over the medium to long term.

The basic indicator for the evaluation of price developments is a price index that covers goods and services consumed by households and which the public at large is accustomed to. In particular, the consumer price index is important in the light of its favorable attributes including timeliness.

Price stability is, conceptually, a state where the change in the price index without measurement bias is zero percent. Currently, there seems to be no significant bias in the Japanese consumer price index. If there is a risk of falling into a vicious cycle of declining prices and deteriorating economic activity, depending on the weight attached to the risk, the accommodation of slight inflation may be deemed consistent with an understanding of price stability in the conduct of monetary policy.

In the case of Japan, the average rate of inflation over the last few decades is lower than major overseas economies. Japan has also experienced a prolonged period of low rates of inflation since the 1990s. Consequently, the rate of inflation at which households and firms perceive price stability seems to be low, and economic decisions may be guided by such a low inflation environment. The conduct of monetary policy must take account of such possibilities.

In today's Monetary Policy Meeting, there was a discussion of the level of inflation rate that each Policy Board member currently understands as price stability from a medium- to long-term viewpoint, in the conduct of monetary policy ("an understanding of medium- to long-term price stability"). While there was a range of views, reflecting the differences in the relative weight attached to factors affecting the understanding of price stability, it was recognized that the level was somewhat lower than that in major overseas economies. It was agreed that, by making use of the rate of year-on-year change in the consumer price index to describe the understanding, an approximate range between zero and two percent was generally consistent with the distribution of each Board member's understanding of medium- to long-term price stability. Most Board members' median figures fell on both sides of one percent. Given that the understanding of medium- to long-term price stability may change gradually reflecting developments such as structural changes in the economy, as a rule, Board members will review it annually.

Attachment 3

March 9, 2006
Bank of Japan

Scheduled Dates of Monetary Policy Meetings in April–September 2006

	Date of MPM	Publication of Monthly Report (The Bank's View)	Publication of MPM Minutes
Apr. 2006	10 (Mon.), 11 (Tue.)	11 (Tue.)	May 24 (Wed.)
	28 (Fri.)	—	June 20 (Tue.)
May	18 (Thur.), 19 (Fri.)	19 (Fri.)	June 20 (Tue.)
June	14 (Wed.), 15 (Thur.)	15 (Thur.)	July 20 (Thur.)
July	13 (Thur.), 14 (Fri.)	14 (Fri.)	Aug. 16 (Wed.)
Aug.	10 (Thur.), 11 (Fri.)	11 (Fri.)	Sep. 13 (Wed.)
Sep.	7 (Thur.), 8 (Fri.)	8 (Fri.)	To be announced

Note: "The Bank's View" in the *Monthly Report of Recent Economic and Financial Developments* (Monthly Report) is scheduled to be published at 3:00 p.m. (this schedule is subject to change on certain grounds such as late closing of the meeting).

Full text of the Monthly Report will be published at 2:00 p.m. on the next business day of the publication of "The Bank's View" (English translation will be published at 4:30 p.m. on the second business day of the publication of "The Bank's View").

"The Bank's View" in the *Outlook for Economic Activity and Prices* (April 2006) will be published at 3:00 p.m. on Friday, April 28, 2006 (the whole report including the background will be published at 2:00 p.m. on Monday, May 1).

THE BANK'S VIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS[10]

Japan's economy continues to recover steadily.

Exports and industrial production have continued to increase. Business fixed investment has continued to increase against the background of high corporate profits. Household income has also continued rising moderately, reflecting the improvement in employment and wages. In this situation, private consumption has become solid. Housing investment has shown some strength. Meanwhile, public investment has been on a downtrend.

Japan's economy is expected to continue to recover steadily.

Exports are expected to continue rising against the background of the expansion of overseas economies. Domestic private demand is likely to continue increasing against the background of high corporate profits and the moderate rise in household income, while structural adjustment pressure, such as the excess debt of firms, has almost dissipated. In light of these increases in demand both at home and abroad, production is also expected to follow an increasing trend. Public investment, meanwhile, is projected to remain on a downtrend.

On the price front, domestic corporate goods prices have continued to increase, mainly reflecting the rise in international commodity prices. The year-on-year rate of increase in consumer prices (excluding fresh food) rose in January.

Domestic corporate goods prices are expected to continue increasing for the time being, mainly due to the effects of the rise in international commodity prices. The year-on-year rate of change in consumer prices is projected to follow a positive trend, albeit with some fluctuations, as supply-demand conditions continue improving gradually.

As for the financial environment, the environment for corporate finance is becoming more accommodative on the whole. The issuing environment for CP and corporate bonds is favorable. Also, the lending attitude of private banks is becoming more accommodative. The lending attitude of financial institutions as perceived by firms has been improving. The decline in credit demand in the private sector is coming to a halt. Under these circumstances, the rate of increase in the amount outstanding of lending by private banks is accelerating, and the amount outstanding of CP and corporate bonds issued has been above the previous year's level. The year-on-year growth rate of the monetary base is around 2.0 percent, and that of the money stock has been at the 1.0–2.0 percent level. As for developments in financial markets, money market conditions continue to be extremely easy, as the Bank of Japan continues to provide ample liquidity. In the foreign exchange and capital markets, stock prices have fallen compared with last month, while the yen's exchange rate against the U.S. dollar and long-term interest rates have been around the same level as last month.

10. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on March 8 and 9, 2006. It is based on information available at the time of the meeting.

The Bank's Thinking on Price Stability

This document is the background notes for "The Bank's Thinking on Price Stability" expressed in "The Introduction of a New Framework for the Conduct of Monetary Policy," decided at the Monetary Policy Meeting on March 8 and 9, 2006.

(An Excerpt from "The Introduction of a New Framework for the Conduct of Monetary Policy")

Price stability is a state where various economic agents including households and firms may make decisions regarding such economic activities as consumption and investments without being concerned about the fluctuations in the general price level.

Price stability is an indispensable prerequisite for realizing sustainable growth, and the Bank of Japan is responsible for realizing price stability through an appropriate conduct of monetary policy. In this regard, given that the effects of monetary policy take time to work through the economy and that volatility of output may actually be amplified when attempts are made to absorb every short-term change in prices resulting from various shocks, the Bank strives to forecast developments in economic activity and prices from a sufficiently long-term viewpoint and to realize price stability over the medium to long term.

The basic indicator for the evaluation of price developments is a price index that covers goods and services consumed by households and which the public at large is accustomed to. In particular, the consumer price index is important in the light of its favorable attributes including timeliness.

Price stability is, conceptually, a state where the change in the price index without measurement bias is zero percent. Currently, there seems to be no significant bias in the Japanese consumer price index. If there is a risk of falling into a vicious cycle of declining prices and deteriorating economic activity, depending on the weight attached to the risk, the accommodation of slight inflation may be deemed consistent with an understanding of price stability in the conduct of monetary policy.

In the case of Japan, the average rate of inflation over the last few decades is lower than major overseas economies. Japan has also experienced a prolonged period of low rates of inflation since the 1990s. Consequently, the rate of inflation at which households and firms perceive price stability seems to be low, and economic decisions may be guided by such a low inflation environment. The conduct of monetary policy must take account of such possibilities.

In today's Monetary Policy Meeting, there was a discussion of the level of inflation rate that each Policy Board member currently understands as price stability from a medium- to long-term viewpoint, in the conduct of monetary policy ("an understanding of medium- to long-term price stability"). While there was a range of views, reflecting the differences in the relative weight attached to factors affecting the understanding of price stability, it was recognized that the level was somewhat lower than that in major overseas economies. It was agreed that, by making use of the rate of year-on-year change in the consumer price index to describe the understanding, an approximate range between zero and two percent was generally consistent with the distribution of each Board member's understanding of medium- to long-term price stability. Most Board members' median figures fell on both sides of one percent. Given that the understanding of medium- to long-term price stability may change gradually reflecting developments such as structural changes in the economy, as a rule, Board members will review it annually.

Background Notes

Price stability is a state where various economic agents including households and firms may make decisions regarding such economic activities as consumption and investments without being concerned about the fluctuations in the general price level.

Price stability is an indispensable prerequisite for realizing sustainable growth, and the Bank of Japan is responsible for realizing price stability through an appropriate conduct of monetary policy.

"Price stability" is defined conceptually as "a state where various economic agents including households and firms may make decisions regarding such economic activities as consumption and investments without being concerned about the fluctuations in the general price level." It is useful to refer to this definition when evaluating whether price stability has been achieved in terms of a price index.

"General prices" is the term used to refer to the aggregation of the prices of individual goods and services. Since general prices cannot be observed directly, a price index compiled by following specific procedures is used to grasp changes in general prices. Even when general prices remain stable, the prices of individual goods and services fluctuate reflecting their supply and demand conditions. As a result, the prices of individual goods and services change relative to one another, with such changes being referred to as "changes in relative prices."

When the price level changes considerably, it becomes difficult for households and firms to accurately identify the factors behind the changes in the prices of individual goods and services: whether such changes reflect shifts in the general price level or movements in the relative prices of goods and services. As a result, the smooth functioning of markets, where price changes provide signals to achieve the efficient allocation of resources, will be inhibited. In general, the prices of individual goods and services tend to fluctuate more as the rate of inflation is higher (Chart 1). Moreover, uncertainty about the outlook for economic activity and prices is amplified when the price level fluctuates considerably, and this makes it difficult for firms to map out their business plans for the long-term. In addition, in financial markets, increased uncertainty about price fluctuations in the future results in the emergence of premiums, with long-term interest rates rising by the corresponding amounts. As a result, when the rate of inflation rises, economic activities with a long-term time frame, including business fixed investment, are likely to be restrained. For those reasons, price stability is an indispensable prerequisite for achieving sustainable growth. Moreover, large price fluctuations may also result in distortions in income distribution.

Given the points mentioned above, Article 2 of the Bank of Japan Law stipulates the principle underlying the Bank's monetary policy conduct as follows: "Currency and monetary control shall be aimed at, through the pursuit of price stability, contributing to the sound development of the national economy." The Bank's pursuit of an appropriate course for monetary policy is based on this principle.

In this regard, given that the effects of monetary policy take time to work through the economy and that volatility of output may actually be amplified when attempts are made to absorb every short-term change in prices resulting from various shocks, the Bank strives to forecast developments in economic activity and prices from a sufficiently long-term viewpoint and to realize price stability over the medium to long term.

Monetary policy influences economic activity, and thereby influences prices after a significantly long and variable time lag (Chart 2). In conducting monetary policy, a central bank is required to forecast developments in economic activity and prices for a sufficiently long period ahead. The Bank presents forecasts for the next one year and a half to two years in the semiannual release of the *Outlook for Economic Activity and Prices*. This is because the Bank thinks it useful to release its forecasts of the future course of economic activity and prices.

The price stability aimed at by a central bank is not short-term or temporary stability, but sustainable stability over the medium to long term. In this regard, it is crucial to assess the factors behind price changes by analyzing whether the current increases or decreases in prices are likely to continue over the medium to long term, and by examining whether a period of stability in the price index is sustainable over the medium to long term.

For example, in the second half of the 1980s, prices in Japan were extremely stable and the year-on-year increase in the consumer price index (CPI; excluding fresh food, on a nationwide basis) remained at 0.6 percent on average in fiscal 1988 even as the bubble was growing (Chart 3). The economy expanded from 1987 and became extremely overheated from 1988 onwards. Looking at the reasons why prices were stable in spite of the economic expansion, in addition to the lag with which monetary easing takes effect, there were also supply-side factors at work: for example, the decline in the cost of imports due to the fall in crude oil prices and the appreciation of the yen. The year-on-year increase in the CPI then gradually rose, but it was not until 1990–91, the last phase of the four-year-long economic expansion, that the CPI reached a level of around 3 percent. In the meantime, asset prices, including land prices, first surged and then fell into a slump, which led to a long period of economic stagnation. It was around 1998 that prices started to follow a moderate declining trend, after an even more substantial time lag.

Central banks around the world forecast developments in economic activity and prices over a sufficiently long period, and strive to achieve price stability in the medium to long term. Looking at the central banks that have adopted inflation targeting, they do not conduct monetary policy mechanically but flexibly. For example, even if the rate of inflation is currently below (above) the target, there are cases when the policy interest rate is raised (lowered) (Chart 4). The target rates of inflation under the inflation targeting regimes and the rates given in the numerical definition of price stability are regarded as something that should mainly be achieved in the medium to long term (Chart 5).

> The basic indicator for the evaluation of price developments is a price index that covers goods and services consumed by households and which the public at large is accustomed to. In particular, the consumer price index is important in the light of its favorable attributes including timeliness.

Various price indexes are available, such as the consumer price index (CPI), the corporate goods price index (CGPI), the corporate service price index (CSPI), and the GDP deflator, which differ in terms of their coverage of goods and services and their index formula.

The Bank makes use of a variety of price indexes when checking price developments, taking due account of their specific attributes given differing compilation methods. In explaining monetary policy to the public, the Bank employs price indexes which cover the goods and services consumed by households, since the public is accustomed to these indexes. In particular, the CPI is important in the light of its favorable attributes, including timeliness. Central banks in major overseas economies employ price indexes that cover goods and services consumed by households, and especially the CPI, as their principal indicators (Chart 6).

Looking at recent price developments using the CPI and other price indexes (Chart 7), the CPI is in the process of consolidating a positive trend, reflecting improvements in supply and demand conditions, increases in wages, and a more favorable outlook for inflation. The year-on-year increase in the CGPI is fluctuating at the 2 percent level due to the hike in international commodity prices. This rate of increase in the CGPI is the highest since 1981, excluding the period from 1989–90 when the CGPI increased reflecting the introduction of the consumption tax. In contrast, the GDP deflator continues to exhibit a year-on-year decrease, reflecting the increase in crude oil prices, since imports are deducted when calculating GDP (Chart 8). The GDP deflator tends to move in the same direction as the CPI in the long term, but sometimes moves differently in the short term. In addition, it should be noted that the GDP deflator is retroactively revised frequently and considerably (Chart 9).

> Price stability is, conceptually, a state where the change in the price index without measurement bias is zero percent. Currently, there seems to be no significant bias in the Japanese consumer price index.

Price stability, expressed in a numerical value of an actual price index, is conceptually a state where a change in a price index without measurement bias is zero percent.

The CPI aims to trace price fluctuations by assuming that all households continue to purchase a given consumption basket which is fixed in the base year. The CPI is unable to thoroughly reflect changes in consumer behavior in response to, for example, the introduction of new goods, including IT-related goods whose prices tend to decline rapidly, and the increased market share of discount outlets in retail markets. The rate of inflation measured by the CPI has thus been considered to be overestimated (Chart 10). In recent years, Japan's Statistics Bureau has made constant efforts to improve the CPI, by for example enhancing its quality-adjustment methods and increasing the frequency with which goods and services included in the CPI are reviewed (Chart 11). As a result, the upward bias in the Japanese CPI has substantially narrowed and is now insignificant.

> If there is a risk of falling into a vicious cycle of declining prices and deteriorating economic activity, depending on the weight attached to the risk, the accommodation of slight inflation may be deemed consistent with an understanding of price stability in the conduct of monetary policy.

Japan's CPI (excluding fresh food, on a nationwide basis) was on a mild declining trend from 1998 and temporarily marked a year-on-year decline of 1.0 percent in 2001. The rate of decline in the CPI then gradually narrowed after 2003 and the CPI marked an increase of 0.5 percent in January 2006. The cumulative rate of decline (adjusted for the effects of the increase in the consumption tax rate) for the eight year period from 1997 through 2005 was 2.7 percent (Chart 12).

If prices are moving persistently upward or downward, resource allocation and income distribution are adversely affected, regardless of the direction of changes. In addition to these adverse effects, costs intrinsic to declining prices are often mentioned. The first reason for such costs is the downward rigidity of nominal wages. If nominal wages are downwardly rigid, price declines will cause real wages to rise, thereby reducing demand for labor and raising unemployment. The increase in unemployment is likely to result in deteriorating economic activity caused by declines in income and the subsequent reduction in spending, thereby triggering a further decline in prices. The second reason is the zero lower bound on nominal interest rates encountered by monetary policy. Nominal short-term interest rates, which are a policy instrument, cannot be lowered below zero percent. When nominal short-term interests decline to virtually zero, monetary policy is unable to lower nominal short-term interest rates in response to declining prices or deteriorating economic activity. Thus, monetary policy is unable to reduce real short-term interest rates to stimulate economic activity. As a result, declining prices and deteriorating economic activity may become more serious. The third reason is the fact that financial transactions are generally contracted on a nominal basis. This means that a decline in prices increases the real value of debts. There is the possibility that a vicious cycle of declining prices and deteriorating economic activity may be triggered, since debtors generally have higher propensity to expend than creditors, thus resulting in reduced aggregate expenditure.

Given the possibilities described above, it may be deemed necessary to decide in advance to accommodate slight inflation in preference to the risk of declining prices. This is "the safety margin" that acts as a buffer against the risk of declining prices. The size of the safety margin largely depends on how the above mechanisms work in Japan's economy in its current state. Specifically, it relies on the assessment of the points below.

(1) The degree of downward rigidity of nominal wages: If labor markets function flexibly and nominal wages are set flexibly, real wages are adjusted smoothly, regardless of the level of inflation rate. This makes the safety margin less important.

(2) The level of the potential growth rate: If the potential growth rate is projected to be relatively high, the equilibrium level of real interest rates will also be higher. So even when real market interest rates rise due to a decline in prices, equilibrium real interest rates are still likely to exceed real market interest rates. This also tends to diminish the importance of the safety margin.

(3) The robustness of the financial system: If stability in the financial system is maintained even with temporarily declining prices, the vicious cycle of declining prices and deteriorating economic activity is unlikely to be aggravated. This also makes the safety margin less important.

(4) The availability of fiscal policy: If fiscal policy has some leeway to take stimulative measures in

response to the risk of a vicious cycle of declining prices and deteriorating economic activity, the safety margin becomes less important.

(5) The effectiveness of monetary policy: Even facing the zero lower bound on short-term nominal interest rates, if the effectiveness of monetary policy is maintained by influencing expectations about the future course of short-term interest rates via a policy commitment regarding policy duration, the safety margin again becomes less important.

Major overseas economies have occasionally experienced temporary declines in prices since the 1980s. In Japan, the CPI marked a year-on-year decline shortly before the bubble period (Chart 12). Germany, Switzerland, Canada, the Netherlands, and Sweden also experienced temporary declines in consumer prices (Chart 13). The issue here is whether a continued decline in prices triggers a vicious cycle of declining prices and deteriorating economic activity. Japan's economy, following its recovery on the back of the worldwide IT boom, experienced deterioration in economic activity after 2001 due to the bursting of the worldwide IT bubble, and also experienced mild declines in prices that lasted until recently. Japan's economy, however, did not fall into a vicious cycle of declining prices and deteriorating economic activity (Chart 14).

Some hypotheses concern why Japan's economy did not fall into a vicious cycle of declining prices and deteriorating economic activity. First, stability was maintained in the financial system due to ample provision of liquidity by the Bank. Second, nominal wages in Japan were adjusted fairly flexibly from the second half of the 1990s and real wages did not remain at high levels (Chart 15). When comparing the rate of changes in nominal wages in Japan with that of major overseas economies, Japan's nominal wages are highly flexible, even in a downward direction (Chart 16). Third, the policy commitment of the quantitative easing policy in terms of the CPI created expectations that zero interest rates would continue, thereby producing a degree of monetary easing effects. In any case, the size of the safety margin depends on the assessment of the importance of the above points.

In the case of Japan, the average rate of inflation over the last few decades is lower than major overseas economies. Japan has also experienced a prolonged period of low rates of inflation since the 1990s. Consequently, the rate of inflation at which households and firms perceive price stability seems to be low, and economic decisions may be guided by such a low inflation environment. The conduct of monetary policy must take account of such possibilities.

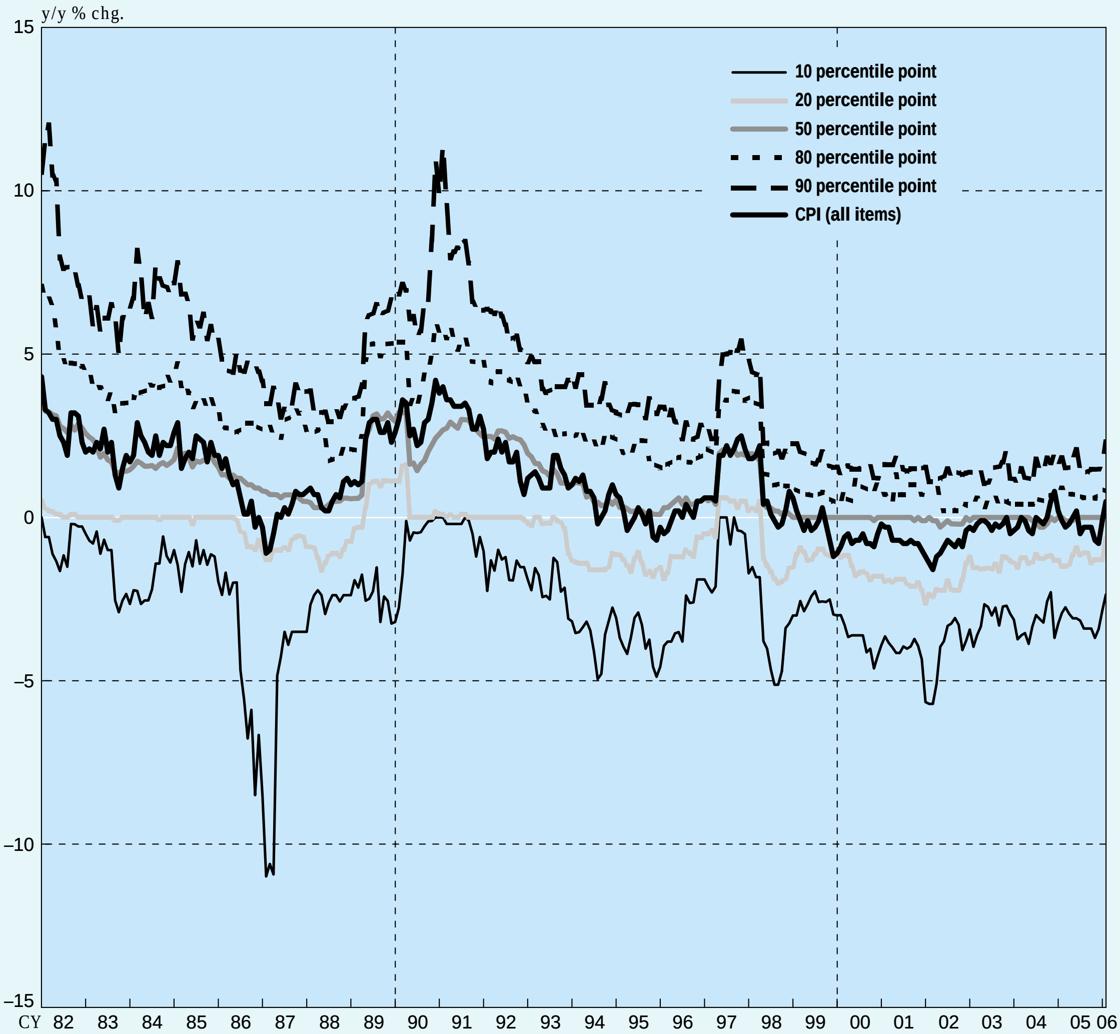
In examining "price stability," it is deemed necessary to take account of the rate of inflation assumed by households and firms when making decisions on economic activities. In that regard, Japan has registered lower rates of inflation than major overseas economies for the last few decades. For example, the average rate of inflation in Japan from 1985 through 2005 was 0.6 percent, which was lower than that of the United States (3.2 percent) and the United Kingdom (2.9 percent) as well as that of countries with relatively low inflation such as Germany (1.8 percent) and Switzerland (1.9 percent) (Chart 17). The same price developments were seen in the average inflation from 1985 through 1997, a period which excludes the years after 1998 when prices in Japan started to trend mildly downward. Given this state of affairs, the rate of inflation at which households and firms perceive prices to be stable may have fallen to a low level. They may therefore be making decisions on economic activities based on such low rates of inflation. This possibility is also suggested by the fact that long-term interest rates have stayed at a relatively low level compared with major overseas economies (Chart 18).

In today's Monetary Policy Meeting, there was a discussion of the level of inflation rate that each Policy Board member currently understands as price stability from a medium- to long-term viewpoint, in the conduct of monetary policy ("an understanding of medium- to long-term price stability"). While there was a range of views, reflecting the differences in the relative weight attached to factors affecting the understanding of price stability, it was recognized that the level was somewhat lower than that in major overseas economies. It was agreed that, by making use of the rate of year-on-year change in the consumer price index to describe the understanding, an approximate range between zero and two percent was generally consistent with the distribution of each Board member's understanding of medium- to long-term price stability. Most Board members' median figures fell on both sides of one percent. Given that the understanding of medium- to long-term price stability may change gradually reflecting developments such as structural changes in the economy, as a rule, Board members will review it annually.

Adverse effects of price fluctuations on the economy vary from country to country, depending on, for example, their economic structure and their track records for inflation. Measurement biases in price indexes also vary from country to country, depending on differences in compilation methods. The level of the inflation rate that each Policy Board member currently understands as price stability from a medium- to long-term viewpoint in the conduct of monetary policy ("an understanding of medium- to long-term price stability") was recognized as being somewhat lower than major overseas economies.

The response of the inflation rate to the economic growth rate is quite weak in the current recovery phase in Japan, compared with past recovery phases (Chart 19). This phenomenon of a weak response of inflation is also seen in overseas economies. In the background lie factors that include the effects of progress in economic globalization and in information and telecommunication technology. In addition, Japan's economy, which is now in the process of attaining a sustainable growth path after a long period of economic stagnation, may be experiencing changes in the price formation mechanism. Although it is difficult to judge at the moment whether such changes are only temporary phenomena or not, there is a possibility that the price formation mechanism will gradually evolve in response to structural changes in the economy. It is thus deemed appropriate to regularly review "the understanding of medium- to long-term price stability."

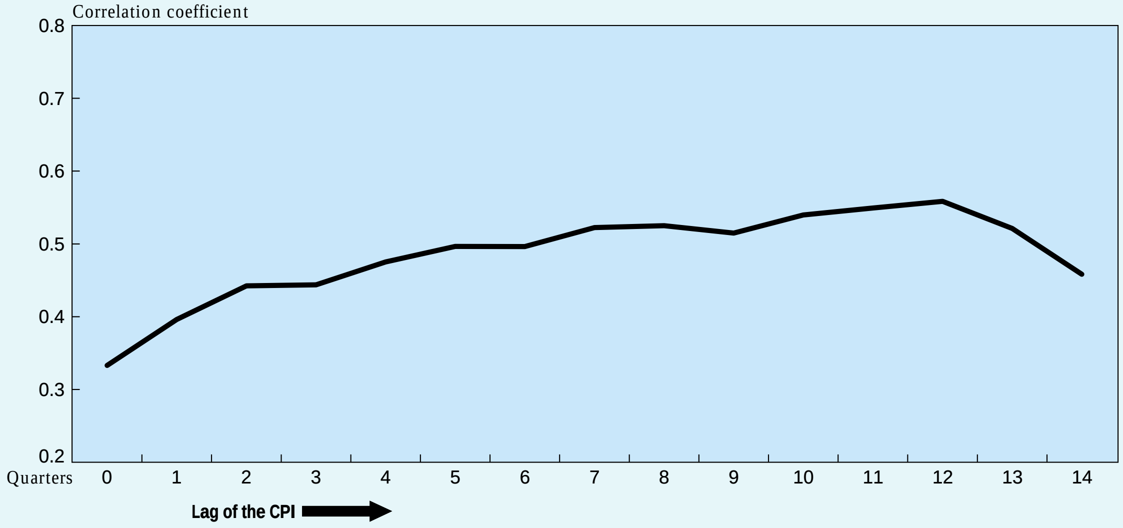
Chart 1
Distribution of Price Changes for Individual Items in the CPI



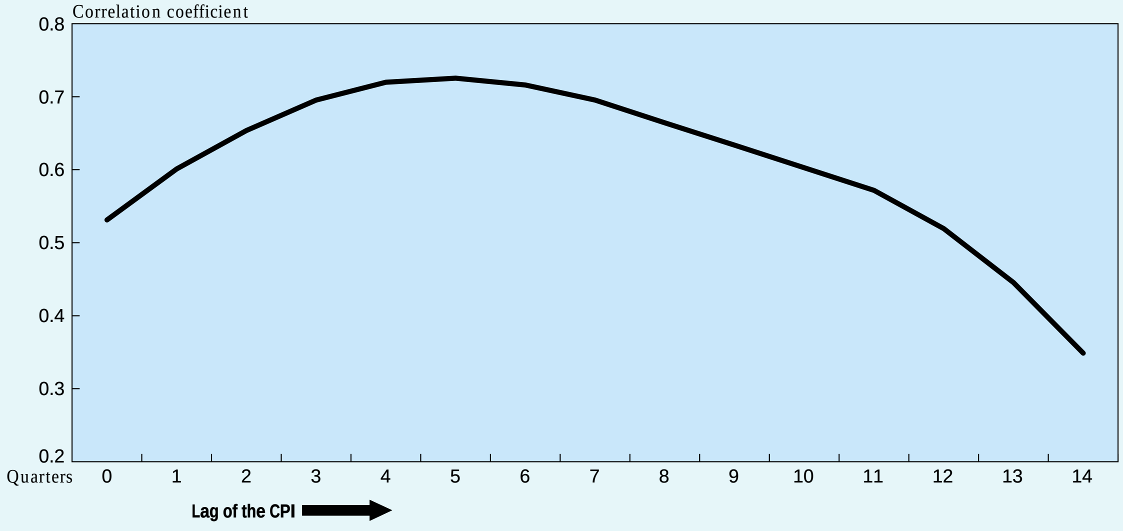
Note: X percentile point shows the rate of price change of the item whose accumulated weight is equal to X%.
Source: Ministry of Internal Affairs and Communications, "Consumer Price Index."

Chart 2
Lead and Lag Relationship between Economic Activity and Prices[1]

(1) Dynamic Cross-Correlation between Real GDP (y/y % chg.) and CPI (excluding fresh food, y/y % chg.)[2]



(2) Dynamic Cross-Correlation between *Tankan* Business Conditions DI and CPI (excluding fresh food, y/y % chg.)[2]

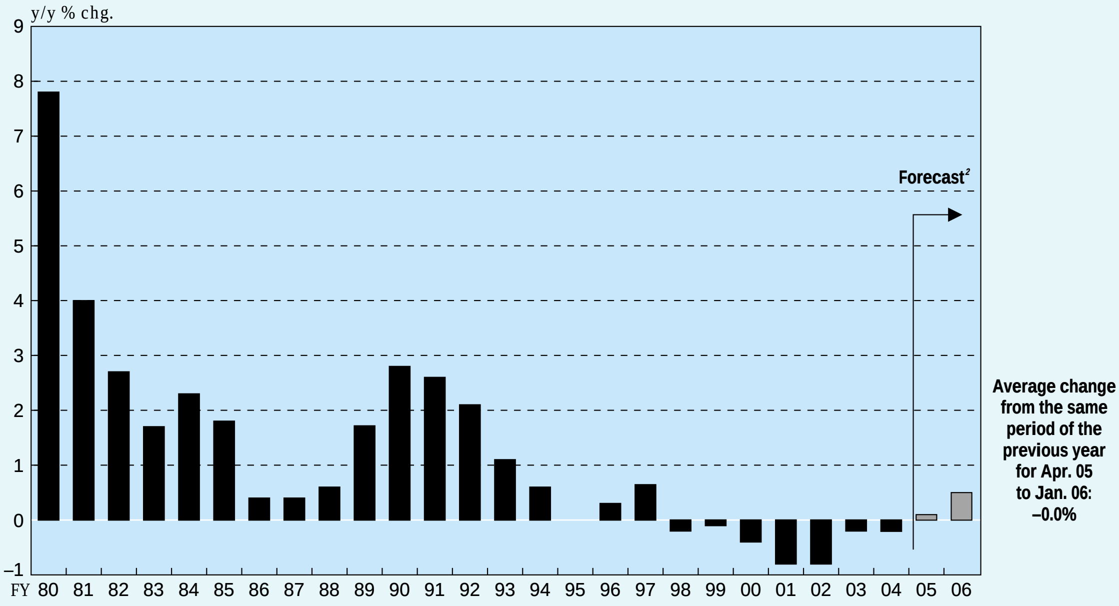


Notes: *1.* Sample period for the dynamic cross-correlation estimation is from 1983/Q1 to 2005/Q4.
2. CPI is adjusted to exclude the effects of changes in the consumption tax rate.
Tankan Business Conditions DI covers all enterprises.

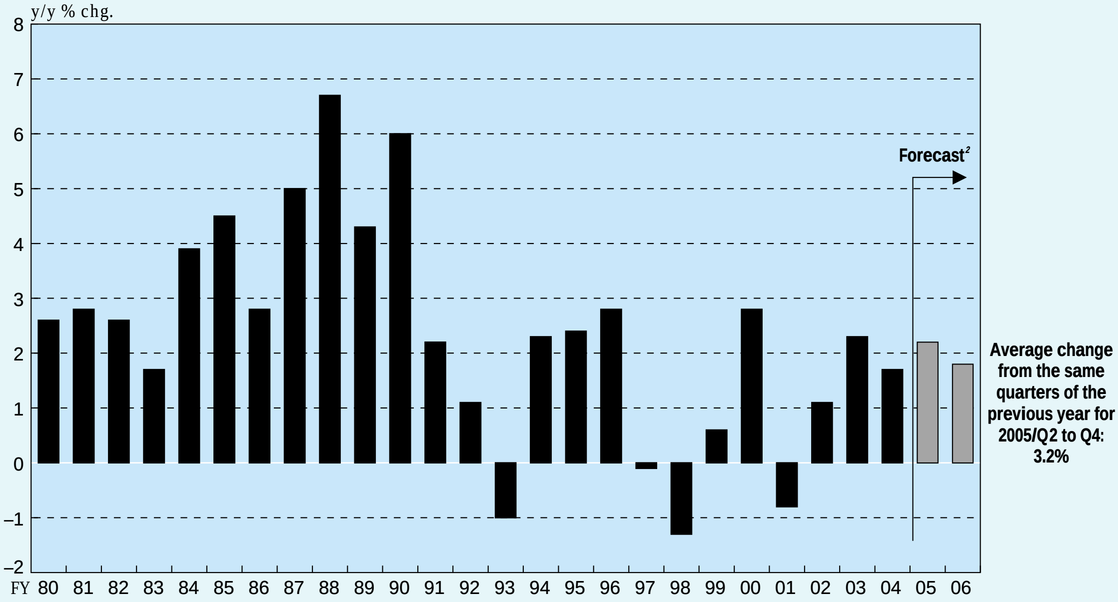
Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

Chart 3
CPI and Real GDP

(1) CPI (excluding fresh food)[1]



(2) Real GDP

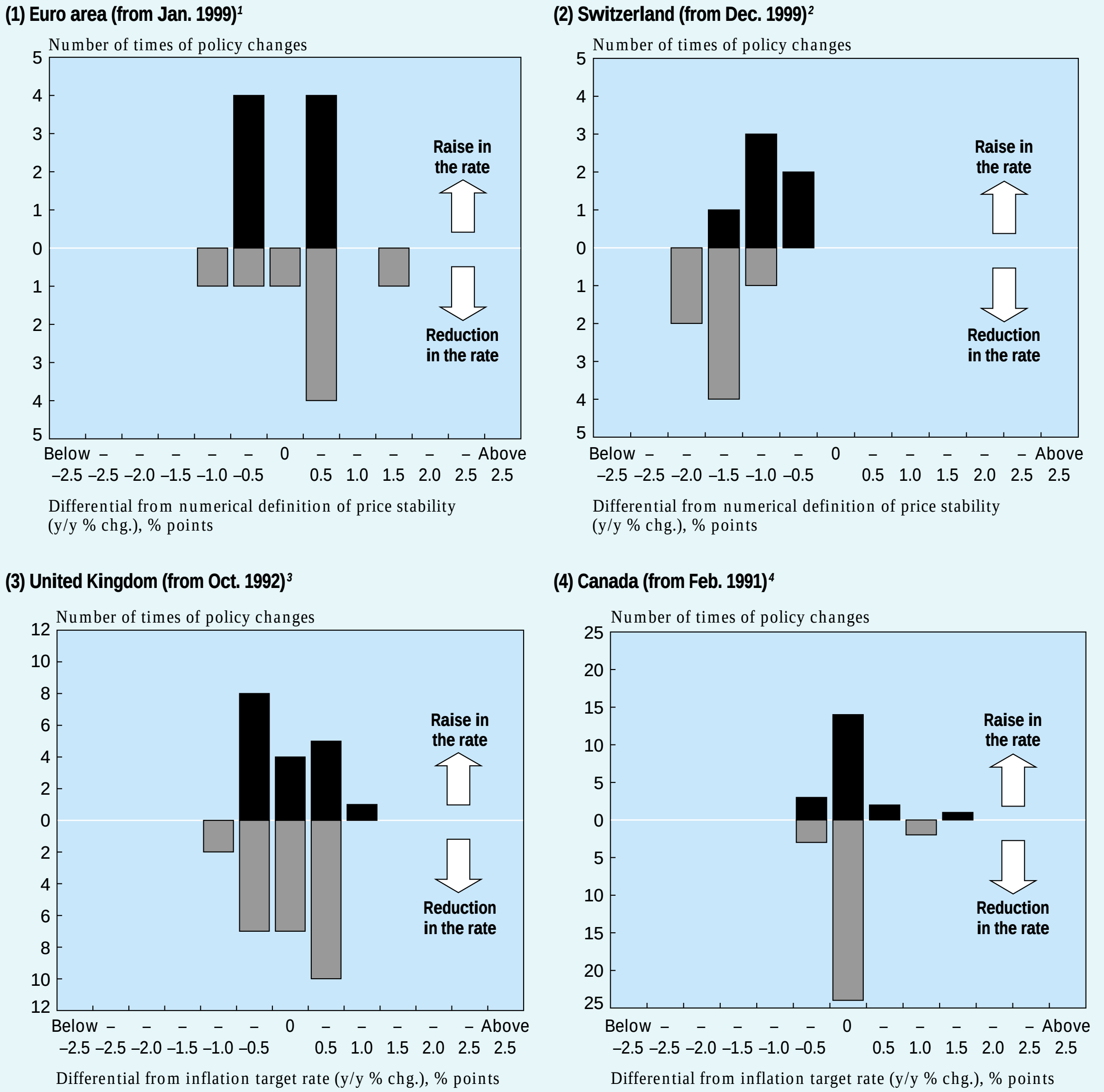


Notes: *1.* CPI is adjusted to exclude the effects of changes in the consumption tax rate.
2. Figures for FY 2005 and 2006 are the medians of forecasts of Policy Board members in the *Outlook for Economic Activity and Prices* (October 2005).

Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Consumer Price Index."

Chart 4

Consumer Prices at the Time of Monetary Policy Changes



Notes: 1. Price indicator for the Euro area is the HICP (all items). Numerical definition of price stability (y/y % chg.) is set to 2%.

2. Price indicator for Switzerland is the CPI (all items). Numerical definition of price stability (y/y % chg.) is set to 2%. In June 2004, the upper bound of the target range of the key policy rate was changed (from 0–0.75% to 0–1%), and this was considered as a raise in the rate.

3. Inflation target rate (y/y % chg.) for the United Kingdom is (1) 1–4% of the RPIX up to May 1995, (2) 2.5% of the RPIX from June 1995 to Nov. 2004, and (3) 2% of the CPI (all items) from Dec. 2004.

4. Price indicator for Canada is the CPI (all items). Inflation target rate (y/y % chg.) is (1) 3±1% up to Dec. 1992, (2) 2.5±1% from Jan. 1993 to June 1994, and (3) 2±1% from July 1994. The key policy rate up to Feb. 1996 had been set at 25 basis points above the average yield on 3-month treasury bills, and no policy change was assumed for the period until then.

Chart 5

Inflation Target Rate or Numerical Definition of Price Stability in Major Economies

Country/Area	Adoption of inflation targeting rate or numerical definition of price stability	Indicator	Inflation target rate or numerical definition of price stability	Average y/y % change of the indicator[1,2]
New Zealand	**Apr. 1988**	**CPI (all items, y/y % chg.)**	**1 to 3%**	**2.6%**
Canada	**Feb. 1991**	**CPI (all items, y/y % chg.)**	**1 to 3% aim at the 2% target midpoint**	**2.1%**
United Kingdom	**Oct. 1992**	**CPI (all items, y/y % chg.)**	**2%**	**1.7%**
Sweden	**Jan. 1993**	**CPI (all items, y/y % chg.)**	**At 2%, with a tolerance range of ±1% point**	**1.5%**
Australia	**Mid-1993**	**CPI (all items, y/y % chg.)**	**Between 2 and 3%**	**2.6%**
Euro area	**Jan. 1999**	**HICP[3] (all items, y/y % chg.)**	**Below, but close to, 2%**	**2.0%**
Switzerland	**Dec. 1999**	**CPI (all items, y/y % chg.)**	**Less than 2%**	**1.0%**

Notes: *1.* The sample periods for average changes of the indicators (except those of New Zealand and Australia) are from the time when the inflation target or numerical definition of price stability was adopted to January 2006.
2. CPI is released quarterly in New Zealand and Australia. The sample period for average change of the CPI of New Zealand is from 1988/Q2 to 2005/Q4. That of Australia is from 1993/Q2 to 2005/Q4.
3. HICP is a consumer price index designed for international comparison by using a harmonized methodology.

Chart 6

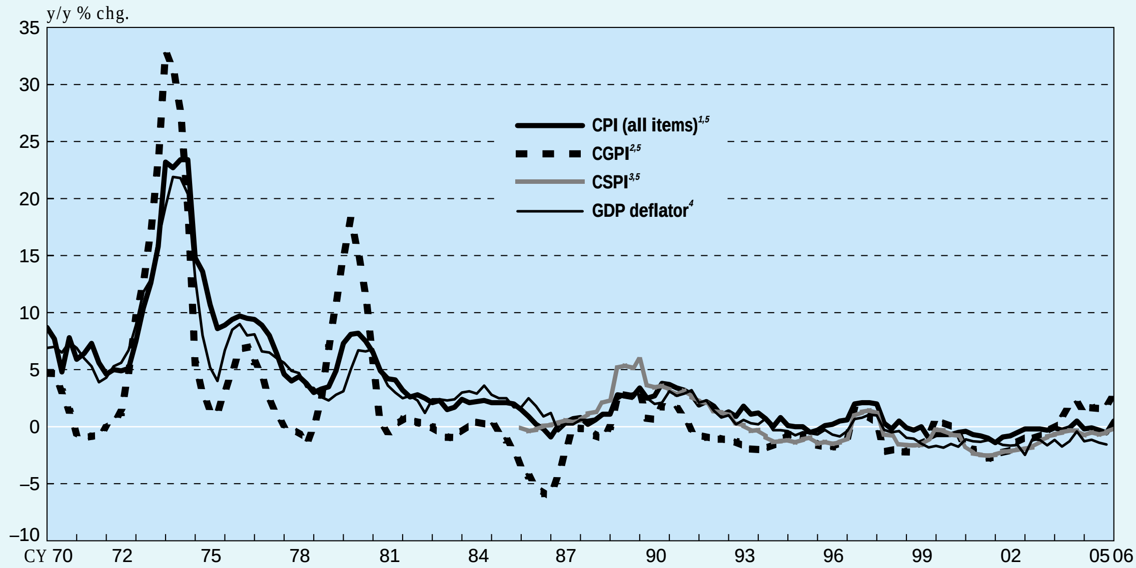
Price Indicators to Explain the Conduct of Monetary Policy

Country/Area	Price indicator	Where price indicator is referred to
Japan	**CPI (excluding fresh food)**	**Forecasts in the *Outlook for Economic Activity and Prices***
United States	**Chain-type price index of PCE (personal consumption expenditures), (excluding food and energy)**	**Projections in the *Monetary Policy Report to the Congress***
Euro area	**HICP (all items)**	**Numerical definition of price stability**
Switzerland	**CPI (all items)**	
United Kingdom	**CPI (all items)**	**Inflation target**
Canada	**CPI (all items)**	
New Zealand	**CPI (all items)**	
Australia	**CPI (all items)**	
Sweden	**CPI (all items)**	
Norway	**CPI (all items)**	

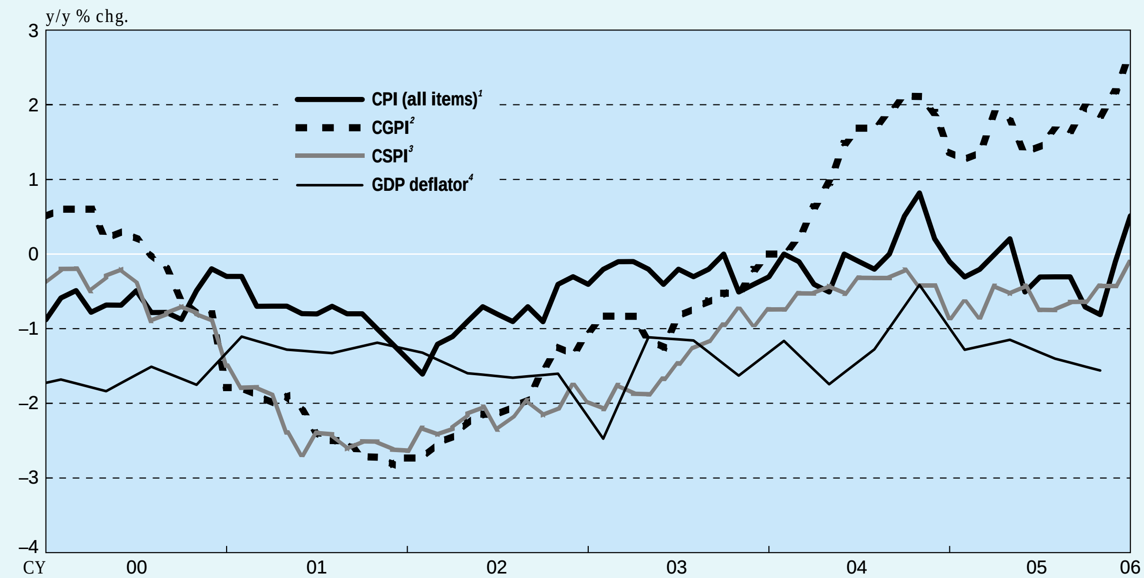
Chart 7

Developments in Various Price Indicators

(1) Developments from 1970



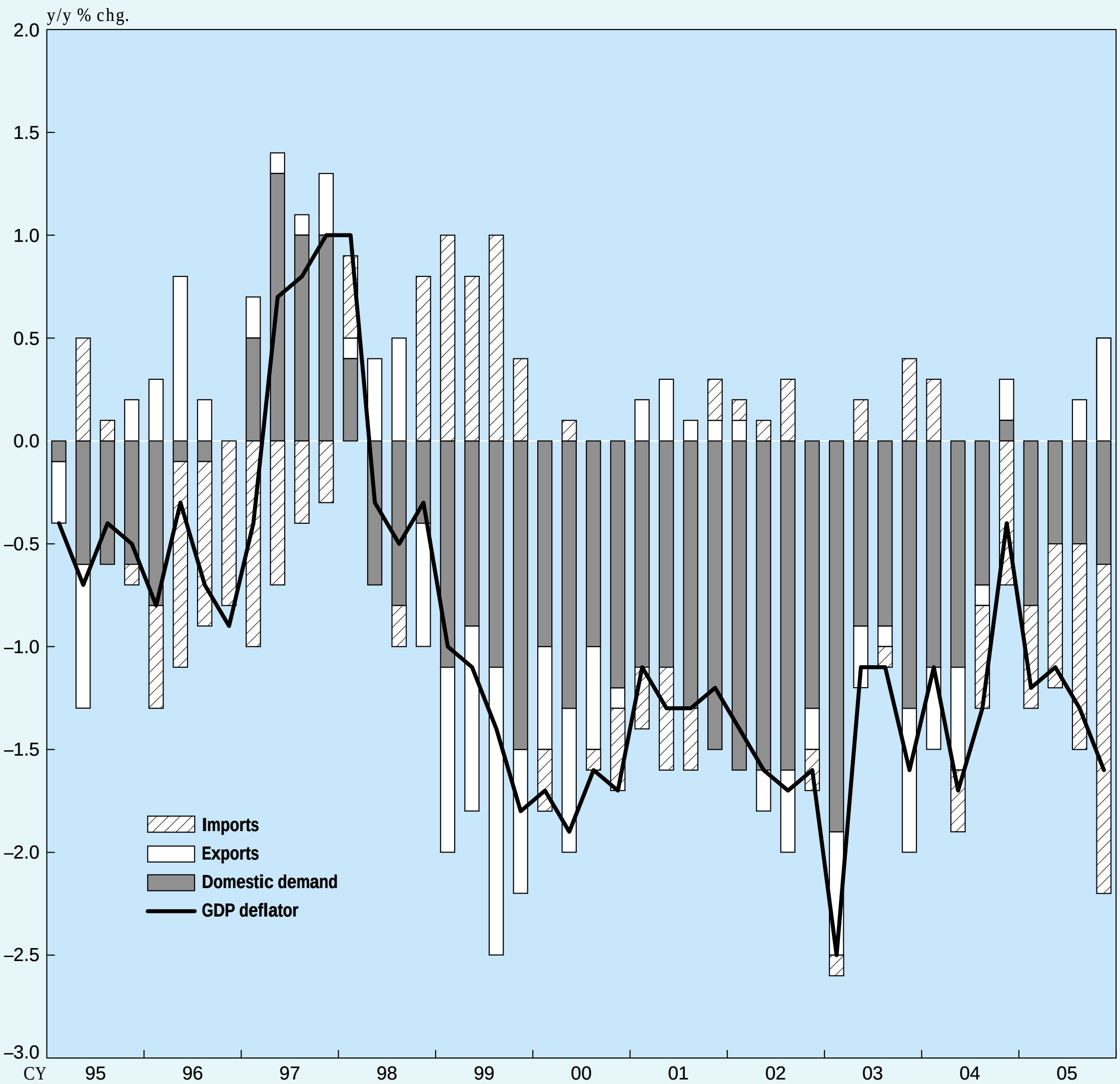
(2) Developments from 2000



Notes: 1. CPI covers the prices of goods and services purchased by households.
2. Figures of the CGPI up to 2000 are those of the WPI (wholesale price index). CGPI and WPI cover the prices of goods traded between firms.
3. CSPI covers the prices of services traded between firms.
4. GDP deflator is the index that shows the effect of price changes on the total value added.
5. Figures for 2006/Q1 are those of January 2006.

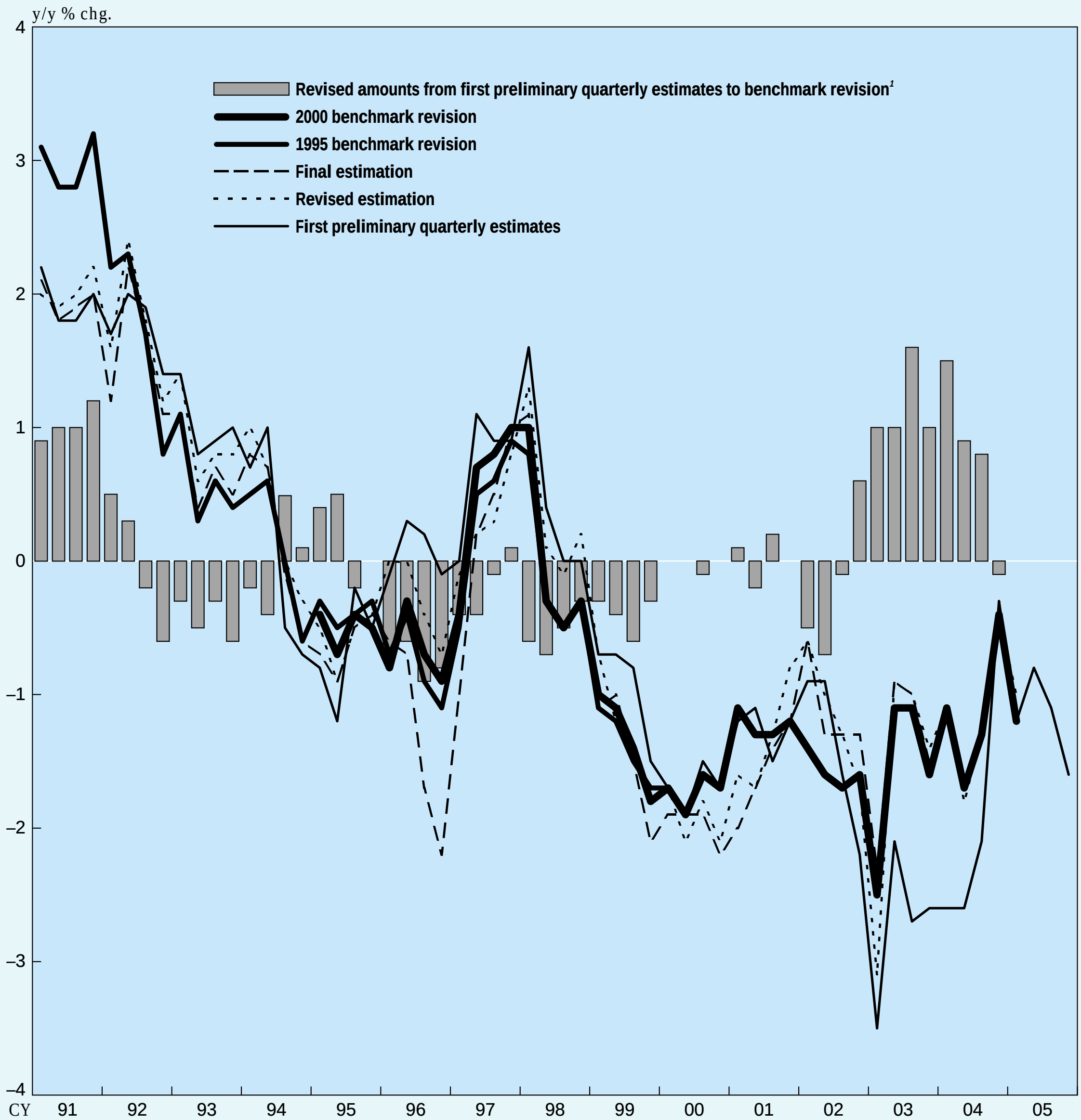
Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bank of Japan, "Corporate Goods Price Index," "Wholesale Price Indexes," "Corporate Service Price Index."

Chart 8
GDP Deflator



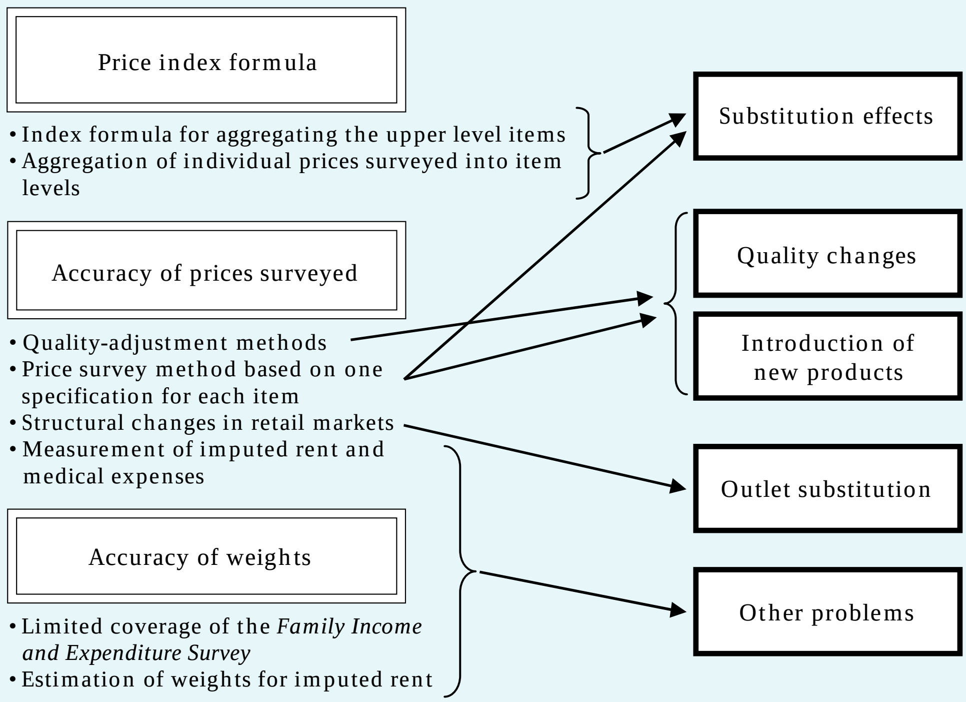
Source: Cabinet Office, "National Accounts."

Chart 9
Revision of GDP Deflator



Note: *1.* Revised amounts until 1994 are those from the first preliminary quarterly estimates to the 1995 benchmark revision, and from 1995, those to the 2000 benchmark revision are used.
Source: Cabinet Office, "National Accounts."

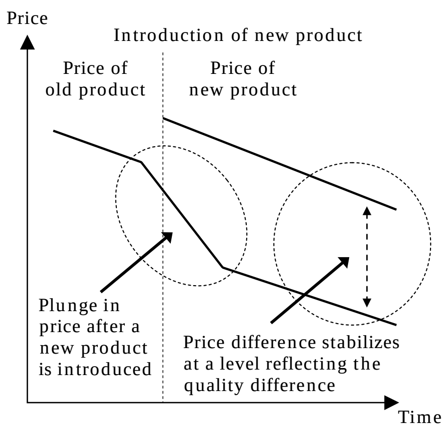
Chart 10
Causes of Measurement Errors in the CPI



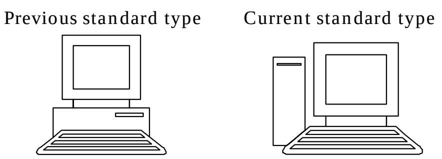
Notes: 1. Substitution effects: The CPI weights are fixed at the base year, and therefore the effects of items whose relative prices are falling or rising are undervalued or overvalued.
2. Quality changes: It is difficult to accurately grasp changes in the quality of items and reflect them in the CPI, and therefore such insufficient quality adjustments cause upward bias of the CPI.
3. Introduction of new products: Consumers purchase a new product when they regard it as relatively less expensive than an old one on a quality-adjusted basis, and therefore a delay in including the new product in the CPI basket causes upward bias.
4. Outlet substitution: It is difficult to reflect in the CPI the impact of consumers' shift to discount outlets, because outlets surveyed are fixed for a certain period of time.

Reference: Main Quality-Adjustment Methods

Overlapping method: Price difference between new and old products sold at the same time is assumed to be equal to the quality difference.



Hedonic method: Statistical estimation of a quality change based on prices and attributes of products.



	Previous year	Current year
Price	0.1 mil. yen	0.1 mil. yen
CPU processing speed	1.5 GHz	3 GHz
Memory capacity	256 MB	512 MB
HD capacity	80 GB	160 GB

Same price but improved functions
↓
Decline in quality-adjusted price

Chart 11

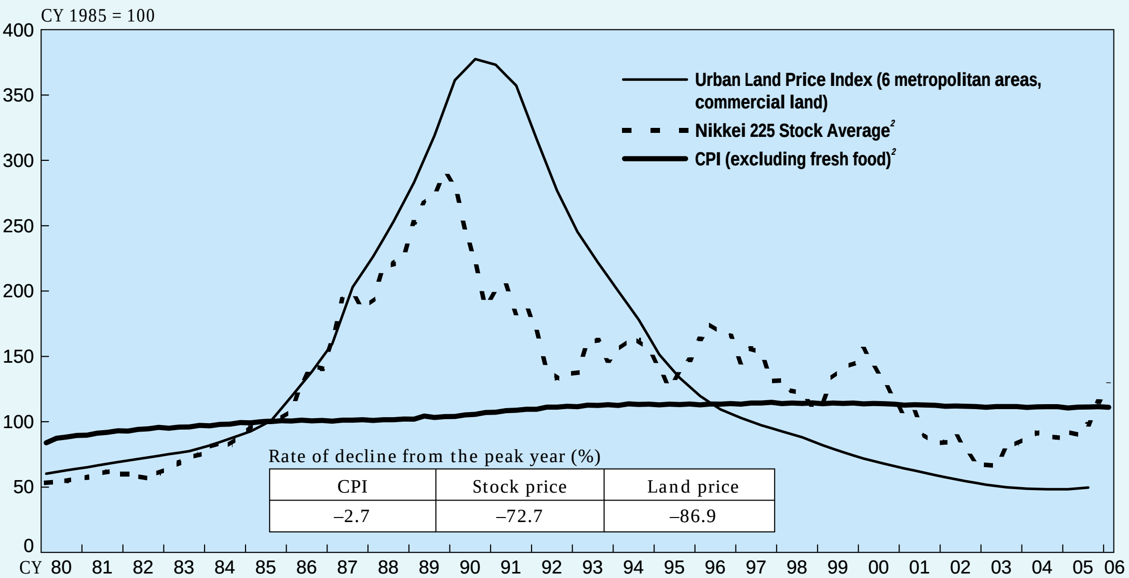
Improvement of the Accuracy of the Japanese CPI

Category	Measure
Quality adjustment	**• PCs were included in the CPI items and their price changes were adjusted with the hedonic method [at the revision of the base year to 2000].** **• Price changes of digital cameras were reflected in the price indexes of cameras and their price changes were adjusted with the hedonic method [at the interim review in 2003].**
Range of outlets surveyed	**• The standard for the range of outlets surveyed was reviewed to facilitate inclusion of large ones in the suburbs [at the revision of the base year to 2000].**
Frequency of review on the items included	**• Items included in the CPI are to be reviewed at the intermediate time of base-year revisions [decided at the revision of the base year to 2000].** **—The first interim review was conducted in January 2003, and PC printers and Internet connection charges were added to the items.**
Index formula	**• The chained Laspeyres index and midpoint-year basket index are to be compiled [starting from the revision of the base year to 2005 that will be conducted in August 2006].**
Weighting	**• Reference index based on the basket of all households including one-person households is to be compiled [starting from the revision of the base year to 2005 that will be conducted in August 2006].**

Chart 12
General Prices and Asset Prices

(1) CPI[1] (excluding fresh food)

(2) CPI[1] (excluding fresh food) and Asset Prices



Rate of decline from the peak year (%)

CPI	Stock price	Land price
–2.7	–72.7	–86.9

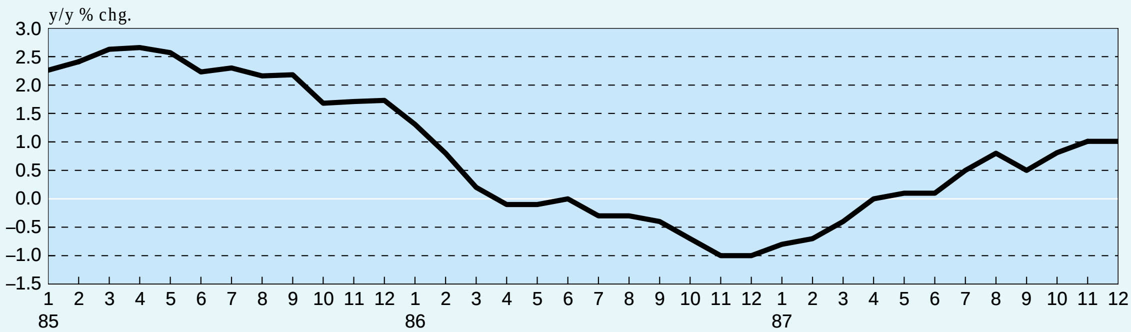
Notes: *1.* CPI is adjusted to exclude the effects of the changes in the consumption tax rate.
2. The figure of Nikkei 225 Stock Average in 2006/Q1 is the average of the latest data available. The figure of the CPI in 2006/Q1 is that of January 2006.

Sources: Ministry of Internal Affairs and Communications, “Consumer Price Index”; Japan Real Estate Institute, “Urban Land Price Index”; *Nihon Keizai Shimbun*.

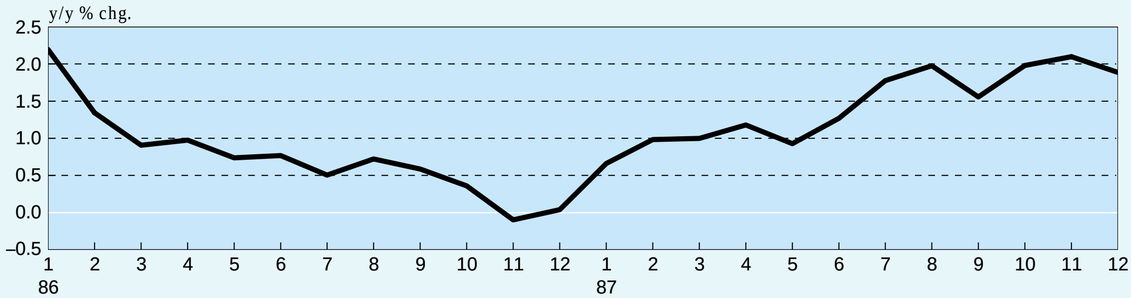
Chart 13-1

Experiences of Negative Year-on-Year Changes in the CPI[1] in the G-10 Countries since 1980 (1)

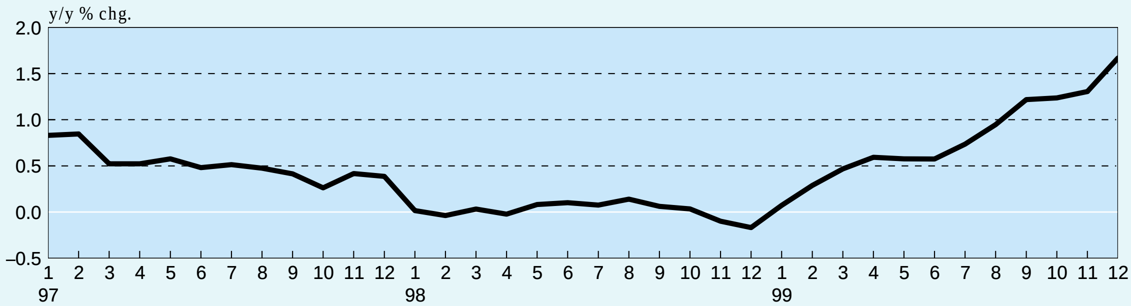
(1) Germany (1986–87)



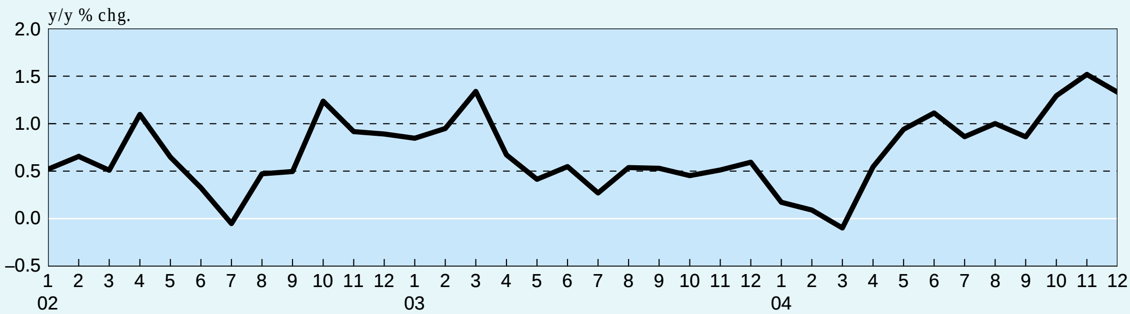
(2) Switzerland: Case 1 (1986)



(3) Switzerland: Case 2 (1998)



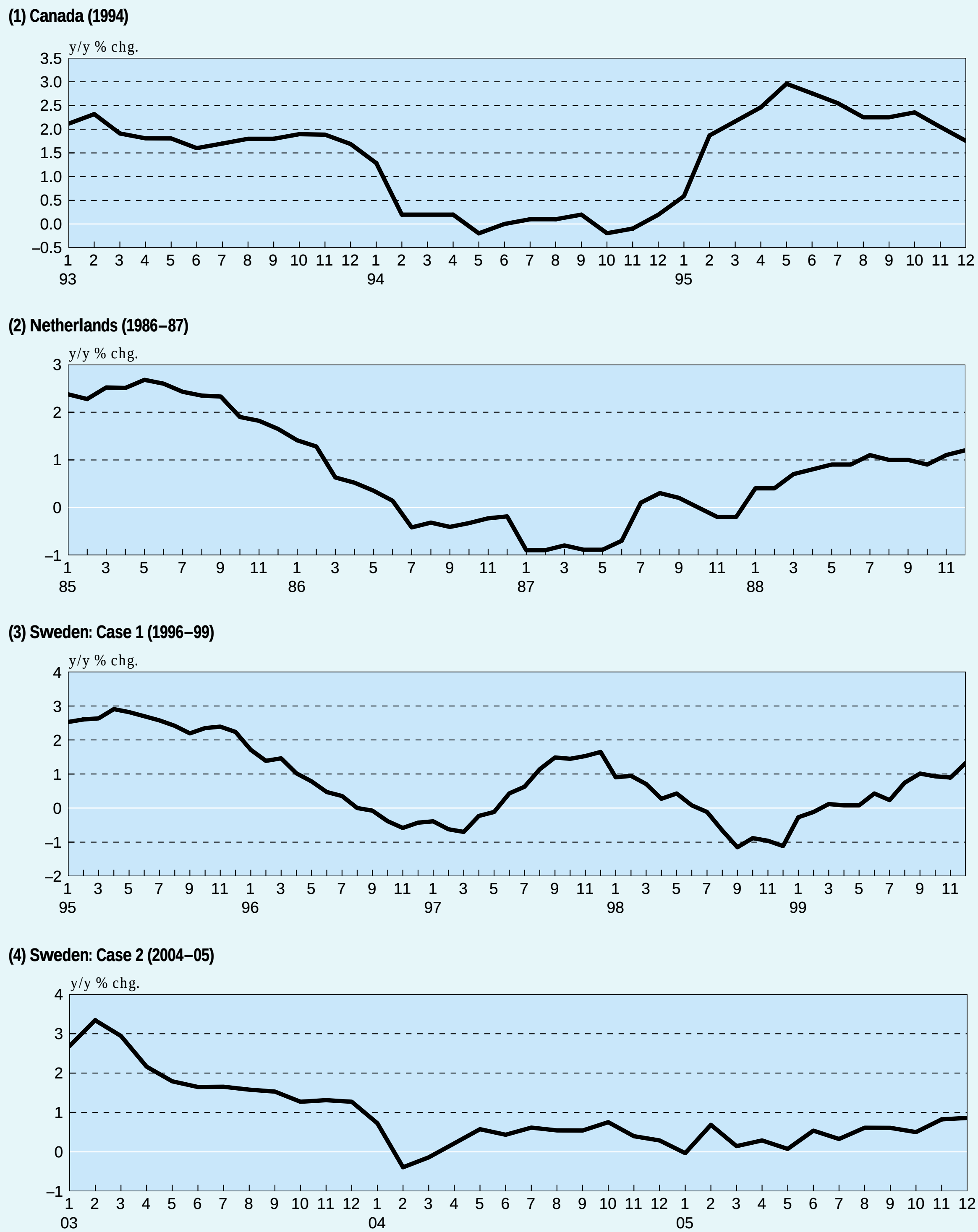
(4) Switzerland: Case 3 (2002 and 2004)



Note: *1*. Figures are based on the CPI including all items.

Chart 13-2

Experiences of Negative Year-on-Year Changes in the CPI[1] in the G-10 Countries since 1980 (2)

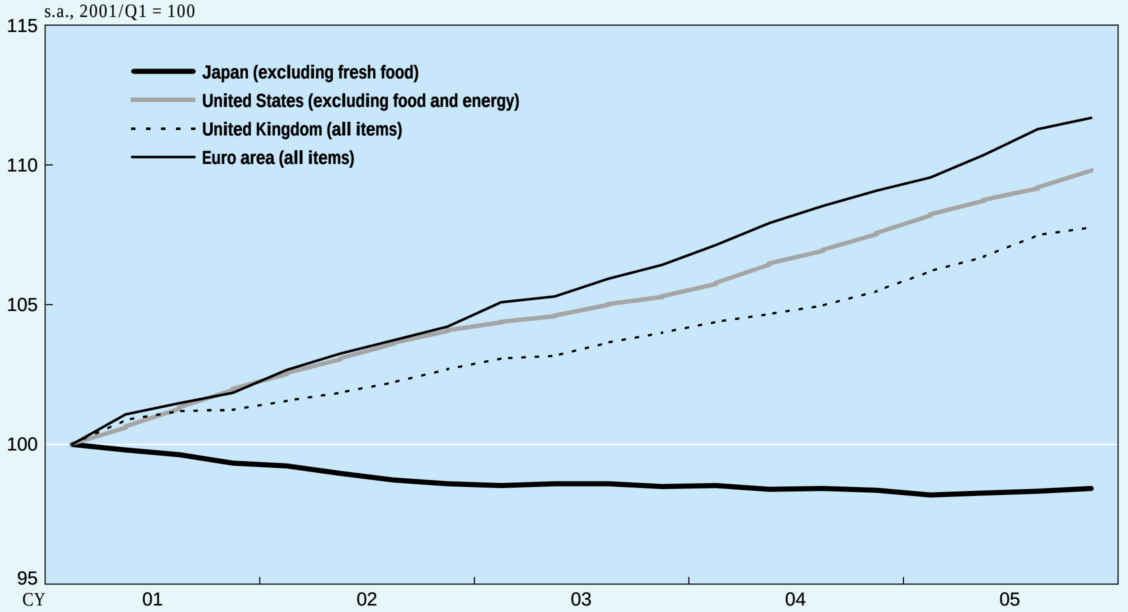


Note: *1*. Figures are based on the CPI including all items.

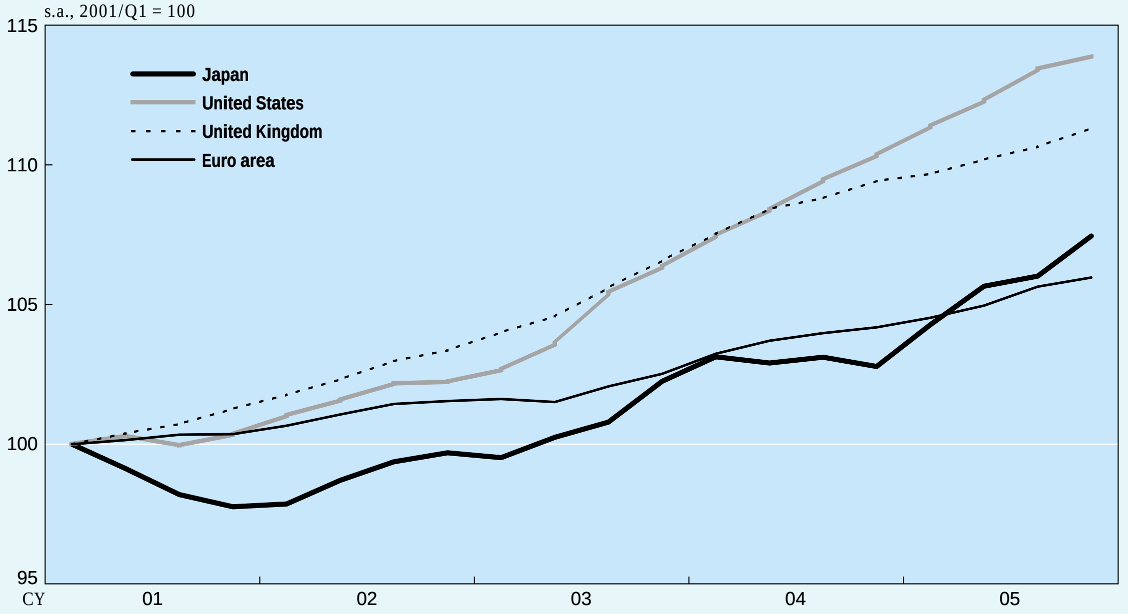
Chart 14

CPI and Real GDP in Major Economies

(1) CPI



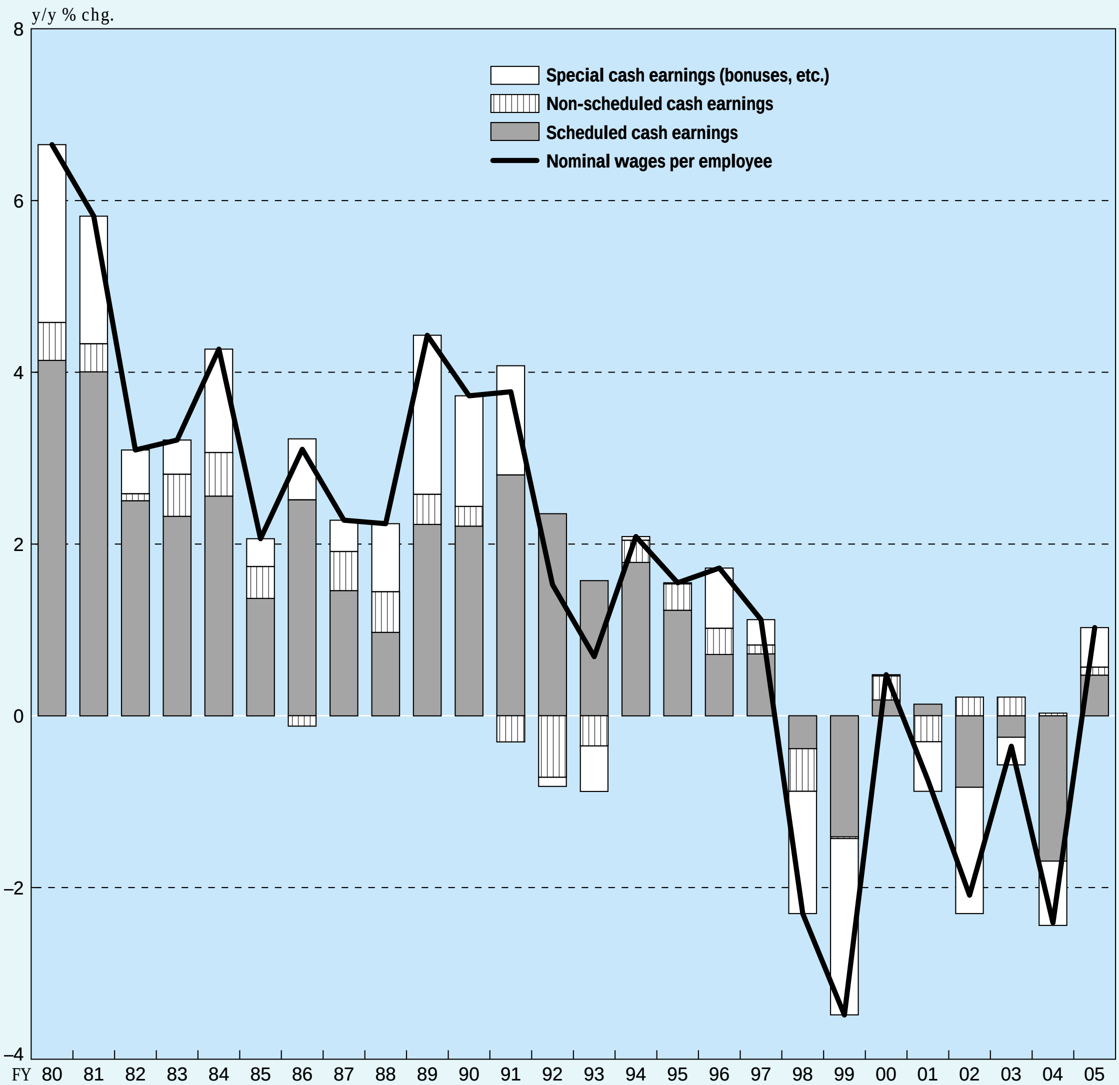
(2) Real GDP



Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; government announcements.

Chart 15

Nominal Wages per Employee

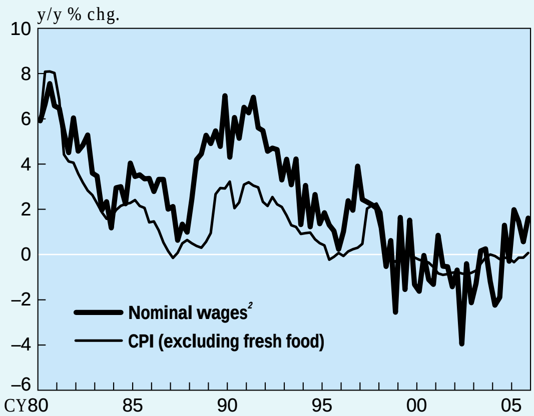


Notes: *1*. Data are for businesses with at least 30 employees.
2. Figures for FY 2005 are those of Apr. 2005–Jan. 2006.
Source: Ministry of Health, Labour and Welfare, "Monthly Labour Survey."

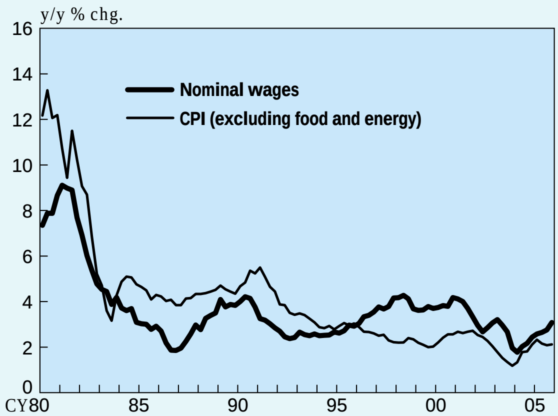
Chart 16

Nominal Wages[1] and Consumer Prices in Major Economies

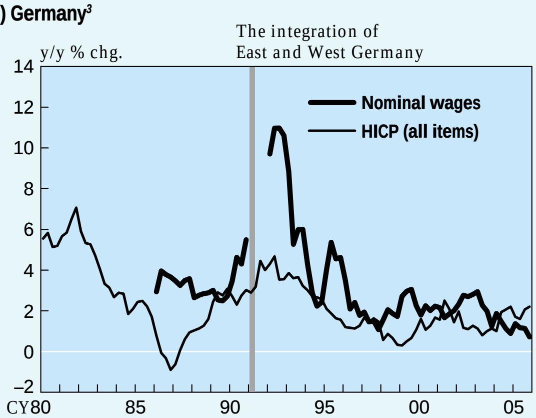
(1) Japan



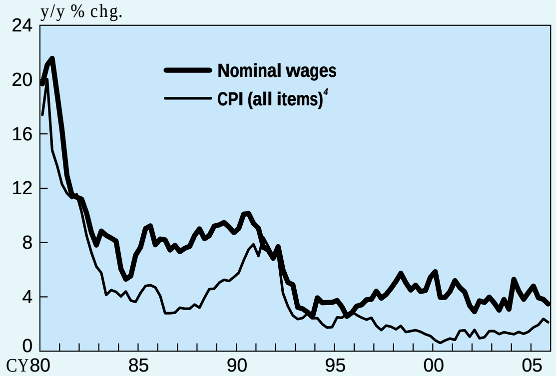
(2) United States



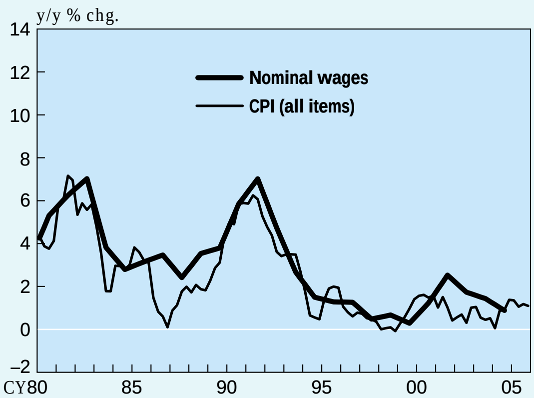
(3) Germany[3]



(4) United Kingdom



(5) Switzerland



Notes:

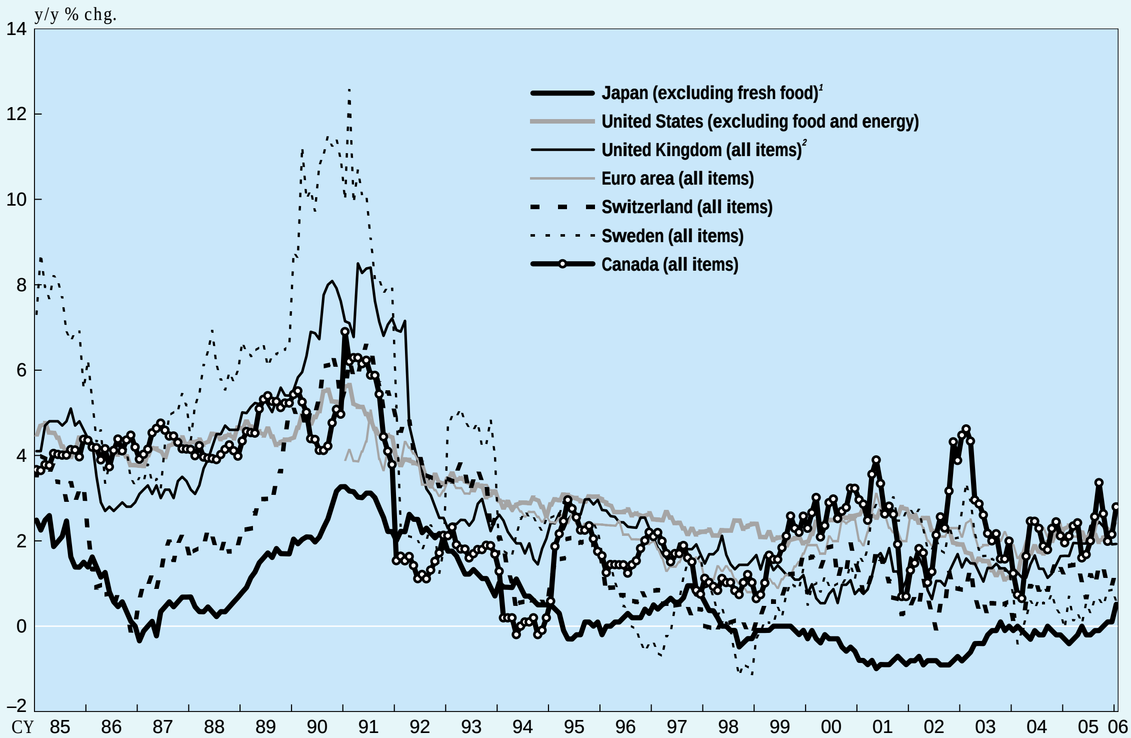
1. Figures of nominal wages are on a per hour basis in Japan and the United States. Those in Germany, the United Kingdom, and Switzerland are on a per employee basis.
2. Figures of nominal wages in Japan are data for businesses with at least 30 employees.
   Q1 = Mar.–May, Q2 = June–Aug., Q3 = Sep.–Nov., Q4 = Dec.–Feb.
   The figure of the latest quarter is that of Dec. 2005–Jan. 2006 compared with the same period of the previous year.
3. Figures of nominal wages and the HICP until 1990 are those of the former West Germany. HICP is used from 1996 and the CPI was used until 1995.
4. Figures of the CPI in the United Kingdom until 1988 are calculated by subtracting 0.5% point from the year-on-year changes in the RPIX.

Sources:
Ministry of Internal Affairs and Communications, “Consumer Price Index”; Ministry of Health, Labour and Welfare, “Monthly Labour Survey”; government announcements.

Chart 17

Consumer Prices in Major Economies

(1) Developments from 1985



(2) Average of Changes during the Specified Periods

y/y % chg.

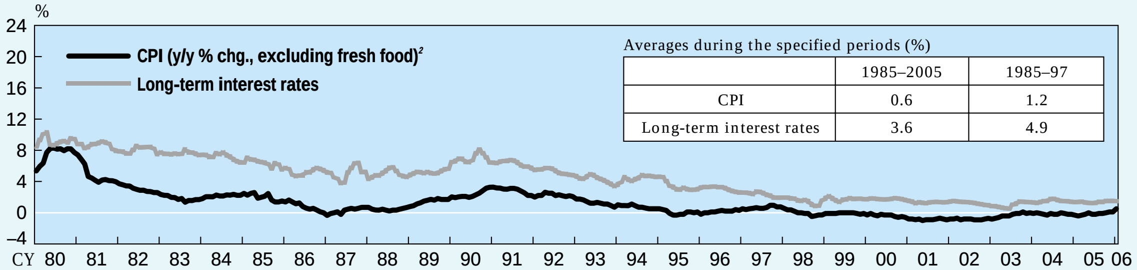
	1985–89	90–94	95–99	2000–05	1985–2005	1985–97
Japan[1]	1.0	1.9	0.2	–0.4	0.6	1.2
United States	4.3	4.0	2.5	2.1	3.2	3.8
United Kingdom[2]	4.1	4.7	2.0	1.3	2.9	3.9
Euro area	—	3.4	1.7	2.2	2.4	2.8
Germany[3]	1.3	3.3	1.2	1.6	1.8	2.1
Switzerland	2.1	3.9	0.8	1.0	1.9	2.6
Sweden	5.6	5.8	0.8	1.4	3.3	4.7
Canada	4.3	2.8	1.6	2.4	2.8	3.1

Notes: *1.* Figures for Japan are adjusted to exclude the effects of changes in the consumption tax rate.
2. Figures for the United Kingdom until 1988 are calculated by subtracting 0.5% point from the year-on-year changes in the RPIX.
3. Figures for Germany up to 1990 are those of the former West Germany.

Chart 18

Long-Term Interest Rates[1] and Consumer Prices in Major Economies

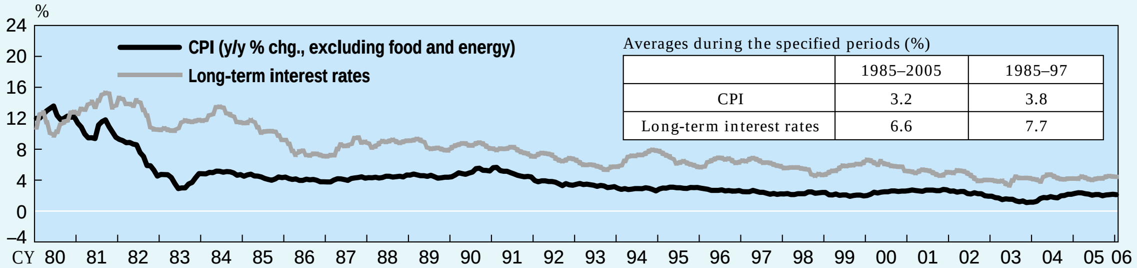
(1) Japan



Averages during the specified periods (%)

	1985–2005	1985–97
CPI	0.6	1.2
Long-term interest rates	3.6	4.9

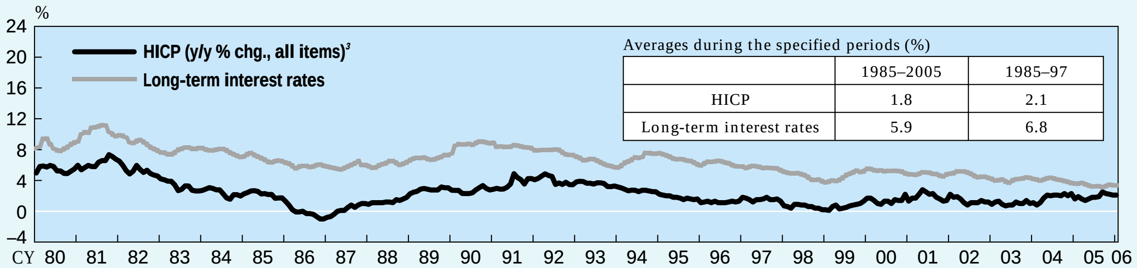
(2) United States



Averages during the specified periods (%)

	1985–2005	1985–97
CPI	3.2	3.8
Long-term interest rates	6.6	7.7

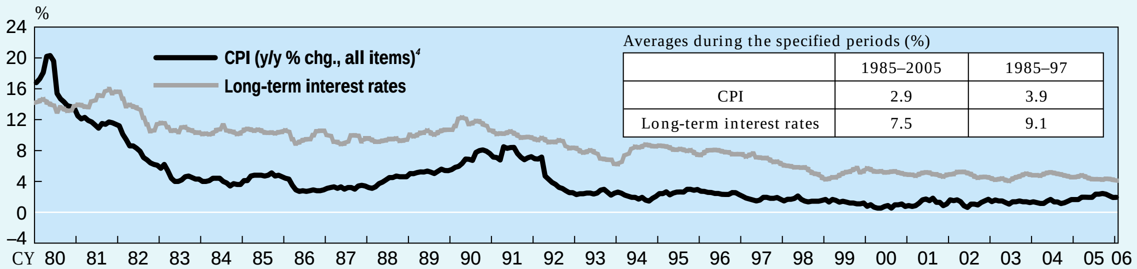
(3) Germany



Averages during the specified periods (%)

	1985–2005	1985–97
HICP	1.8	2.1
Long-term interest rates	5.9	6.8

(4) United Kingdom

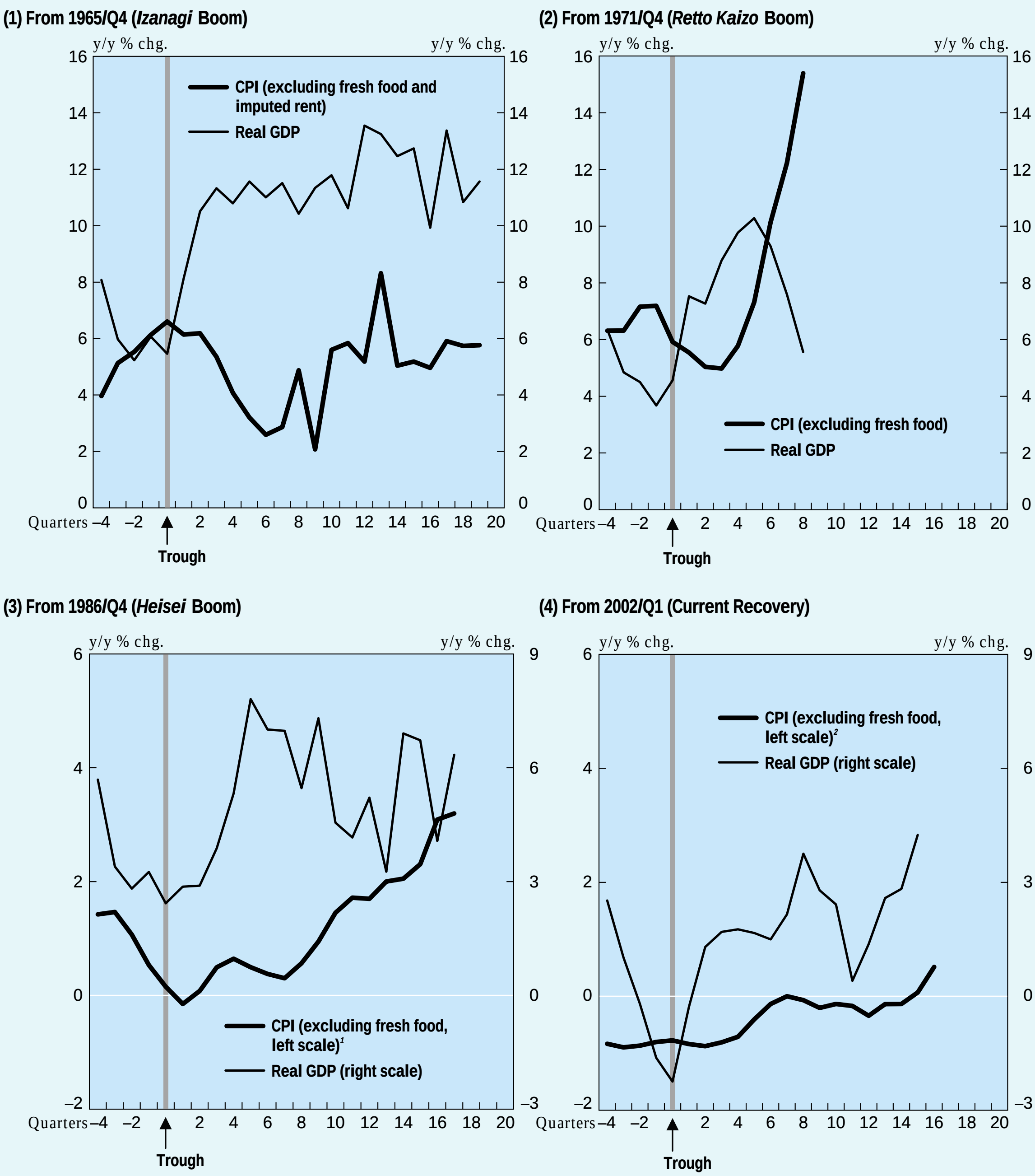


Averages during the specified periods (%)

	1985–2005	1985–97
CPI	2.9	3.9
Long-term interest rates	7.5	9.1

Notes: *1.* Long-term interest rates are 10-year government bond yields.
2. CPI for Japan is adjusted to exclude the effects of changes in the consumption tax rate.
3. Figures of the HICP until 1990 are those of the former West Germany. HICP is used from 1996 and the CPI was used until 1995.
4. Figures of the CPI for the United Kingdom until 1988 are calculated by subtracting 0.5% point from the year-on-year changes in the RPIX.

Chart 19
Developments in the CPI through Economic Recovery Phases



Notes: *1*. CPI is adjusted to exclude the effects of changes in the consumption tax rate.
2. The figure of the CPI in the latest period, 2006/Q1, is that of January 2006 compared with the same month of the previous year.

Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Consumer Price Index."

The Bank of Japan's Action Plans for Fiscal 2006

INTRODUCTION

The Bank of Japan has formulated the Medium-Term Strategic Framework (MTSF) for fiscal 2005–2009, which was released in March 2005.[1] The Action Plans for Fiscal 2006 comprises the set of issues and concrete action plans that the Bank should tackle during the coming fiscal year, the second year of the MTSF, in order to achieve the goals specified in the MTSF. It also details the principles for the Bank's organizational management and the resources (i.e., its administrative expenses, resources for information technology [IT] investment, and human resources) necessary to fulfill the planned actions.

During fiscal 2005, the first year of the MTSF, the Bank took various actions to pursue more advanced central banking services. To achieve its strategic goals, the Bank has improved its business infrastructure, for example, via the organizational reform of its Head Office including the establishment of the Financial Systems and Bank Examination Department and the Payment and Settlement Systems Department. The Bank will release in Japanese an evaluation of its progress toward the strategic goals stated in the MTSF in the *Gyoumu Gaikyo Sho* (Outline of Business Operations) in May 2006, excerpts of which will be translated into English and included in the *Annual Review* published every September.

After reviewing the progress made during fiscal 2005, the Action Plans for Fiscal 2006 was formulated with the aim of reinforcing the capability of the Bank so as to enhance its services while maintaining the two core principles and the eight strategic goals laid out in the MSTF.

I. Major Issues and Action Plans

The major issues facing the Bank in fiscal 2006 and action plans to tackle them are classified according to the eight strategic goals laid out in the MTSF.

A. Strengthening Policy Planning Capabilities

With the environment surrounding the economy and financial markets in and outside Japan undergoing significant changes, the Bank will endeavor to enhance the quality of its research and analysis on developments in economic activity, prices, and the financial environment in order to make appropriate policy decisions. The Bank will also conduct research into medium- and long-term issues that affect the outlook for the Japanese economy.

1. Upgrading the quality of its analysis of developments in economic activity, prices, and the financial environment.
   a. Conducting research and analysis for policy planning, following the termination of the quantitative easing policy and the introduction of a new framework for the conduct of monetary policy.
   b. Further strengthening the Bank's research capability with regard to Japanese financial markets, and the interdependence of the macroeconomy and the financial system, so as to enhance the quality of the Financial Markets Report, a semiannual report reviewing Japanese financial markets, and the Financial System Report, a regular report on the stability and functionality of the financial system.
   c. Strengthening the quality of the Bank's analysis of regional economies and surveys of business conditions by making effective use of its nationwide network of branches and offices, so as to enhance the quality of the Regional Economic Report, a quarterly report on regional economies.
2. Further enhancing the quality of research and analysis into the effects of structural factors such as those affecting economic activity, prices, and the effectiveness of monetary policy, reflecting the changes in the Japanese economy and the increased global linkages.
3. Strengthening the Bank's IT research capability and promoting the dissemination of information and explanations to the general public through the Bank's Center for Information Technology Studies (CITECS). This is to be achieved, for example, by promoting research on information security and anti-counterfeiting technologies, and enhancing information sharing related to IT within the financial sector by strengthening ties among the entities concerned.
4. Enhancing the activities of the Archive and the Currency Museum.
5. Using scheduled reviews and revisions to improve the quality of statistics compiled by the Bank.
   a. Preparing for the revision of the base year for the Corporate Goods Price Index to 2005,

1. Fiscal 2005–2009 is the period from April 2005 through March 2010.

for release in 2007; revising the sample firms in the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) in March 2007; and taking part in international initiatives to revise the Balance of Payments Manual to be released by the International Monetary Fund (IMF) in 2008.
   b. Participating in the government's discussions on how to improve statistics.

B. Attaining Safer and More Efficient Payment and Settlement Systems and Market Infrastructure

The Bank will work to achieve further sophistication of its payment and settlement services, by making full use of advanced IT, and will also play an active role in promoting further improvement in the stability of private-sector payment and settlement systems. The Bank will also endeavor to improve the functioning of financial markets reflecting changes in the financial environment.

1. Ensuring the daily, smooth operation of its online payment and settlement system, including the Bank of Japan Financial Network System (BOJ-NET).
2. Upgrading the functions of the BOJ-NET as follows:
   a. Introducing more user-friendly BOJ-NET terminals, equipped with improved security features, and employing Internet technology, to be available for practical use from around November 2006.
   b. Promoting the next-generation real-time gross settlement (RTGS-XG) project of the BOJ-NET Funds Transfer System, via two specific measures: the introduction of liquidity-saving features into the RTGS mode; and the modification of the system to enable it to incorporate large-value payments currently handled by private-sector deferred net settlement systems.
3. Working toward the revision of the Bank's current account services and cash services in response to diversified branch strategies at financial institutions.
4. Taking the initiative in promoting further improvement in the safety and efficiency of private-sector payment and settlement systems.
5. Moving forward with initiatives for improving the functioning of the money market, Japanese government securities (JGS) markets, and credit markets (e.g., the corporate bond and CP markets, the securitization market, and the syndicated loan market) by taking account of changes in the financial environment after the termination of the quantitative easing policy.
6. Improving the procedures of its money market operations and the acceptance of eligible collateral in order to conduct market operations more smoothly and improve the convenience of counterparties in these operations.
   a. Achieving paperless transactions for outright purchases of bills, scheduled for around the middle of fiscal 2006.
   b. Promoting the ongoing revision and improvement of procedures to accept private-sector debt as eligible collateral.
7. Modifying business procedures and computer systems to promote further progress in online processing of treasury funds (government expenses and revenues), and expanding the use of the electronic services offered.
   a. Introducing collective online payment of tax returns, scheduled for September 2006.
   b. Continuing to prepare for the introduction of services such as collective online payment of salaries for government employees.

C. Ensuring Business Continuity Arrangements for Emergencies

The Bank will develop and continually revise its business continuity arrangements and take the initiative in cooperative endeavors with relevant entities to enhance the business continuity ability of the overall financial market and its participant financial institutions.

1. Enhancing and making more specific the business continuity planning (BCP) for emergencies at the Bank's Head Office.
   a. Improving the Bank's alternative operational bases for use should its Head Office be damaged and unable to function and further strengthening the backup capabilities of the Bank's computer systems.
   b. Ensuring the availability of personnel, and reinforcing the necessary infrastructure at the Bank to take account of the People Protection Law and the measures to be put in place in case of earthquakes in the Tokyo area.
2. Taking the initiative in cooperative endeavors with relevant entities to enhance the business continuity ability of the overall financial market, payment and settlement systems, and financial system, in the face of a possible disruption.

a. Encouraging financial institutions and other relevant entities to improve their business continuity arrangements and to enhance drills in preparation for emergency operations, in response to the diversification of risk factors, such as natural disasters and terrorist attacks, that might lead to business interruptions, as well as the formulation of international standards for BCP.

b. Supporting market participants' initiatives in business continuity arrangements by, for example, promoting cooperation between markets and supporting the operation of web sites for BCP.

3. Improving drills in preparation for emergency operations by, for example, conducting joint drills involving financial institutions and government agencies.
4. Formulating a business plan for the Bank, in response to the law on measures to be put in place in case of earthquakes in the Japan and Kuril Island troughs.

D. Enhancing the Functioning of the Financial System

The Bank will continue to put effort into its on-site examinations and off-site monitoring of overall financial institutions by placing more emphasis on enhancing the functioning and robustness of the financial system in Japan. It will also push forward with research and analysis in areas including the financial system and risk management skills. Through these efforts, the Bank will contribute to advances in financial technology in Japan.

1. Conducting on-site examinations and off-site monitoring of financial institutions, and hosting seminars organized by the Bank's Center for Advanced Financial Technology with a view to supporting private-sector initiatives toward providing more efficient and advanced financial services.
   a. With regard to on-site examinations and off-site monitoring, enhancing assessments of the economic value of and risks involved in financial institutions' asset holdings and financial transactions. Encouraging financial institutions to practice integrated risk management and improve the functioning of their internal controls. Working toward the realization of risk management and profit/loss management that are appropriate given changes in the financial environment after the termination of the quantitative easing policy.
   b. Expanding the number and improving the quality of open seminars organized by the Center for Advanced Financial Technology, including those held outside Tokyo, and introducing seminars held on a regular basis, with a view to further sharing understanding and exchanging views with financial institutions. These will provide opportunities for the Bank to contribute to the advancement of the financial institutions' management of risks and business activities.
2. Reinforcing research and analysis related to the financial system and risk management skills.
   a. Promoting the dissemination of information on potential risk and the functioning of the financial system through efforts such as the enhancement of the Financial System Report.
   b. Enhancing the quality of research and studies on advanced financial techniques and risk management methods, and publishing their findings.
3. Participating in discussions on financial system policy held at global forums, and applying the outcomes to contribute to more efficient and advanced financial services.
4. Supporting more advanced financial data exchange with financial institutions. Increasing the use of extensible business reporting language (XBRL) format in online financial data exchange.

E. Enhancing International Operations and Services in response to Globalization

In light of the ongoing trend of globalization in the economy and financial services, particularly the development of closer links between Japan and other Asian economies, the Bank will further strengthen cooperation with other central banks. The Bank will also implement measures to help ensure the stability of the currency system and foster financial markets in Asia.

1. Taking part in various international discussions on issues such as developments in the global economy and international financial markets and strengthening cooperation among foreign central banks.
2. Further strengthening the relationship with other central banks in Asia, with initiatives taken by the Bank's Center for Monetary Cooperation in Asia (CeMCoA), through the promotion of technical assistance, personnel exchanges, and such activities as seminars and joint research.

3. Promoting concrete measures in Asia to foster efficient financial markets and establish a stable currency system.
   a. Planning and promoting projects to improve financial markets in Asia, following the launch of the Asian Bond Fund 2 (ABF2).
   b. Considering more concrete measures to improve and expand the network of bilateral swap arrangements in the Asian region.
4. Managing the Bank's foreign currency assets in a stable and efficient manner.

F. Securing Confidence in the Currency

The Bank will enhance the smooth supply of banknotes and maintain the cleanliness of banknotes in circulation, as well as ensure the safe use of the currency and other means of payment.

1. Maintaining the cleanliness of banknotes in circulation by preventing damaged or worn banknotes from being returned to circulation.
2. Further enhancing smooth banknote supply by improving the transparency and efficiency of cash handling services offered to financial institutions by the Bank.
3. Improving the Bank's counterfeit detection capability through the installment in its branches of the new automatic banknote examination machines with enhanced counterfeit detection features first introduced in fiscal 2005.
4. Strengthening efforts to ensure the security of the currency and other means of payment, and prevent counterfeiting.
   a. Enhancing communication and cooperation with related entities such as ministries and government agencies, and conducting further research on anti-counterfeiting technologies.
   b. Improving public relations activities aimed at achieving better public understanding of anti-counterfeiting measures.

G. Promoting Better Understanding of the Policies and Business Operations of the Bank and Related Financial and Economic Issues

In order to secure public understanding, the Bank aims to conduct its public relations activities from a broad point of view in a timely manner and will continue with efforts to expand its opportunities to explain the Bank's policies and business operations, and improve the quality of its explanatory materials.

1. Working toward publication of the progress in the measures listed in the MTSF and the Action Plans covering a wide range of the Bank's business operations. Endeavoring to acquire information on the public's interests and views on the Bank's policies and operations and making use of them to improve its business operations and enhance public relations activities.
2. Enhancing the Bank's conduct of its public relations activities, particularly speeches, and improving the accessibility and lucidity of its explanations. More specifically: making more active use of the Bank's web site; the introduction of new styles of speeches by executives and staff, including those inviting audience participation; and further improvement in the Bank's In-House Tours.
3. Contributing to better financial education among the public via the following:
   a. Assisting financial education projects carried out by the Central Council for Financial Services Information.
   b. Producing teaching materials for schools and promoting their use, in cooperation with people engaged in education.

H. Improving Regional Services

Making effective use of the strengths of its nationwide network of branches and offices, for each of the strategic goals listed above the Bank will provide services appropriately tailored to regional circumstances.

1. Promoting a smooth supply of clean banknotes, and encouraging the online processing of government expenses and revenues.
2. Researching and analyzing information on regional economies and making use of the results in the Bank's policy implementation, as well as disseminating information on the Japanese economy, including these results, to individual regions.
3. Ensuring the stability of regional financial systems and improving their functioning.
4. Strengthening the accountability of the Bank by thoroughly explaining its policies and business operations and promoting public relations activities.
5. Contributing to financial education in local communities.
6. Enhancing business continuity arrangements.

II. Management Resources and Organizational Management

A. Budget for General and Administrative Expenses and Costs

The Bank's budget for general and administrative expenses and costs for fiscal 2006 (the 122nd fiscal year) is as follows (tables 1 and 2).[2] Note that, while appropriating a significant portion of the budget to deal with the Major Issues and Action Plans outlined in the preceding section, the Bank has also thoroughly examined overall expenditure to achieve a more streamlined budget.

1. The Bank has made great progress in cutting costs. The budget for general and administrative expenses and costs for fiscal 2006 (excluding the cost of fixed-asset purchases and the contingency funds) decreased by 1.2 percent from the previous year to 219.6 billion yen, due mainly to the following decreases from the previous year: 12.6 percent in the cost of production of banknotes; 2.0 percent in the remuneration of executives; 0.4 percent in the remuneration of staff; 0.0 percent in expenses for transportation; 6.3 percent in expenses for communications; 11.2 percent in expenses for maintenance and repairs; 3.4 percent in the cost of expendable supplies; 5.3 percent in leasing fees for buildings and equipment; and 6.3 percent in miscellaneous expenses. On the other hand, administrative expenses for treasury business and government securities increased by 17.9 percent from the previous year due mainly to increases in the redemption of JGSs.
2. The Bank appropriated a total of 15.5 billion yen for fixed-asset purchases, an increase of 12.4 percent from the previous year. The increase is due mainly to the appropriation of the cost of the renovation of the Bank of Japan Naha branch. The cost for updating automatic banknote examination machines, however, decreased. The Bank appropriated 1.0 billion yen for the contingency funds in fiscal 2006, which was the same amount as in the previous year.

B. IT Investment

The scale of system development for fiscal 2006 was set at 10,400 person-months[3] (including outsourcing man-hours of 7,600 person-months), more or less the same level as the previous fiscal year (projected at approximately 10,400 person-months). The Bank will complete the ongoing system development projects begun the previous fiscal year, and select new development projects and set operational tasks in accordance with basic policies specified below.

1. The Bank will steadily carry out system development projects necessary for fulfilling its MTSF for fiscal 2005–2009, in particular, those for attaining safer and more efficient payment and settlement systems and market infrastructure, and ensuring business continuity arrangements for emergencies.
2. The Bank will determine the priority and amount of human resources to be accorded to system development projects upon ascertaining their relevancy, urgency, and cost-effectiveness, and after reviewing the business and operational procedures to which the projects are to apply.
3. The Bank will seek to improve the efficiency of its system development by, for example, making use of new technology and evaluating the results of ongoing projects as well as integrating projects that use similar technologies.

C. Ceiling on the Number of Employees (Table 3)

While ensuring that the Bank has the staff necessary to fulfill its Major Issues and Action Plans, the Bank will make further efforts to raise the efficiency of existing business operations and achieve a net decrease in the number of employees. This policy will also be in line with the General Principles of Administrative Reform decided by the Cabinet in December 2005. The ceiling on the number of Bank employees for fiscal 2006 was set at 5,245, a decrease of 15 employees from the previous fiscal year.

D. Organizational Management

1. Through the examination and coordination, under the Management Committee, of Bank-wide

2. The Bank prepares a budget for general and administrative expenses and costs every fiscal year. Its budget for core operations, excluding the cost of purchasing fixed assets used for the Bank's business operations, is subject to the approval of the Minister of Finance under Article 51, Paragraph 1 of the Bank of Japan Law before the beginning of each fiscal year. For fiscal 2006, the Bank sought approval on March 17, 2006, and will implement the budget upon authorization from the Minister of Finance.
Figures appearing in the text and tables of the Action Plans are rounded.
3. In system development, one person-month is the workload equivalent of one person working for one month.

issues, the Bank will implement the MTSF and Action Plans for each fiscal year, monitor its progress toward its published strategic goals, and assess its achievements; meanwhile, the Bank will allocate management resources efficiently.

2. Following deliberations by the Compliance Committee, the Bank will, for example, seek to raise executives' and staff's awareness of their obligation to comply with the requisite laws and regulations in performing their duties, to reinforce the protection of personal information, and to enhance the management of information security.
3. With the aim of enhancing organizational flexibility, the Bank will abolish the division system currently in place in the Currency Issue Department, Operations Department, and Administration Department in July 2006, and make necessary arrangements to divide the departments by section.
4. The Bank will continue to execute all operations with precision and stability, backed up by reliable practical knowledge. To this end, the Bank will seek to identify risks through measures such as the assessment of business processes and will encourage the adoption of preemptive risk reduction measures. The Bank will reinforce a proper monitoring and management of the operation of the BOJ-NET and other systems; make efforts to maintain and improve their quality through system development; and continue to take all necessary measures to ensure their stable operations.
5. Through operational restructuring in light of the advances in IT, constant review of business processes, and information sharing, the Bank will maintain its efforts to further raise the efficiency of operations and promote implementation of its high-priority action plans.
6. The Bank will continue to seek new staff with diverse skills and enhance staff training aimed at acquiring the highly specialized skills and a broad point of view required for a central bank. The Bank will also ensure that the reemployment system (the "senior staff system") introduced in response to the revised Law for the Stabilization of Employment of the Aged becomes firmly established.

Table 1
Budget for General and Administrative Expenses and Costs for Fiscal 2006 (The 122nd Fiscal Year)

Item	Initial budget (thous. yen)	Share[1] (percent)	Change from the previous year (percent)
Cost of production of banknotes	56,380,138	25.7	–12.6
Administrative expenses for treasury business and government securities	49,621,135	22.6	17.9
Personnel expenses	50,978,491	23.2	0.6
Remuneration of executives	**436,472**	**0.2**	**–2.0**
Remuneration of staff	**40,894,357**	**18.6**	**–0.4**
Retirement allowances	**9,647,662**	**4.4**	**5.0**
Expenses for transportation and communications	6,166,293	2.8	–4.0
Expenses for transportation	**2,367,316**	**1.1**	**–0.0**
Expenses for communications	**3,798,977**	**1.7**	**–6.3**
Expenses for maintenance and repairs	1,659,295	0.8	–11.2
Other expenses and costs	54,830,040	25.0	–3.4
Cost of expendable supplies	**1,993,635**	**0.9**	**–3.4**
Expenses for electricity and water supply	**2,262,929**	**1.0**	**1.4**
Leasing fees for buildings and equipment	**13,228,151**	**6.0**	**–5.3**
Expenses for maintenance of buildings and equipment	**10,131,612**	**4.6**	**7.0**
Miscellaneous expenses	**27,213,713**	**12.4**	**–6.3**
Subtotal	219,635,392	100.0	–1.2
Cost of fixed-asset purchases	15,547,207	. . .	12.4
Of which: Subject to the approval of the Minister of Finance[2]	**6,448,968**	**. . .**	**–25.0**
Contingency funds	1,000,000	. . .	0.0
Total[3]	236,182,599	. . .	–0.4
Of which: Subject to the approval of the Minister of Finance[2]	**227,084,360**	**. . .**	**–2.1**

Notes: *1.* "…" indicates that figures are not applicable.
2. Excludes the cost of purchasing fixed assets used for the Bank's business operations.
3. Of the budget for general and administrative expenses and costs, expenses for computerization amounted to 32,385,913 thousand yen, a 5.7 percent decrease from the previous year, and are included in expenses for communications, leasing fees for buildings and equipment, expenses for maintenance of buildings and equipment, and miscellaneous expenses.
The budget for expenses related to computerization reflects an estimate for outsourcing man-hours stipulated in Section II.B.

Table 2
Budget for General and Administrative Expenses and Costs for Fiscal 2001–2006

bil. yen

Item \ Fiscal year	2001	02	03	04	05	06
Budget for general and administrative expenses and costs[1]	**205.5**	**219.2**	**222.8**	**226.0**	**222.3**	**219.6**
Reference: Expenses for computerization	**28.6**	**31.6**	**30.9**	**31.9**	**34.3**	**32.4**
Cost of fixed-asset purchases	**25.8**	**24.7**	**12.2**	**16.6**	**13.8**	**15.5**
Total budget for general and administrative expenses and costs[2]	**232.4**	**245.0**	**236.0**	**243.7**	**237.2**	**236.2**

Notes: *1*. Excludes the cost of fixed-asset purchases and the contingency funds.
2. Includes the contingency funds.

Table 3
Annual Ceiling on the Number of Employees for Fiscal 2001–2006

people

Fiscal year	2001	02	03	04	05	06
Ceiling on the number of employees	**5,530**	**5,370**	**5,260**	**5,260**	**5,260**	**5,245**

On-Site Examination Policy for Fiscal 2006

I. Review of On-Site Examinations and Off-Site Monitoring of Financial Institutions in Fiscal 2005[1]

A. Number of Financial Institutions Examined

In fiscal 2005, the Bank of Japan conducted on-site examinations at a total of 160 financial institutions: 42 domestically licensed Japanese banks, 73 *shinkin* banks, and 45 other institutions including securities companies and Japanese branches of foreign banks (see Table below).

B. Conditions in the Financial System Observed through On-Site Examinations and Off-Site Monitoring

The Bank released a paper in March 2005 entitled "The Bank of Japan's Measures regarding the Financial System after the Full Removal of Blanket Guarantee of Deposits." In this paper, the Bank clarified its intention to shift its focus in financial system policy from crisis management to supporting private-sector initiatives aimed at providing more efficient and advanced financial services via fair competition, while maintaining overall system stability. Under this policy, the Bank conducted on-site examinations and off-site monitoring in fiscal 2005 with a view to encouraging financial institutions' efforts to improve their management of risks and business activities, while standing ready to act as the lender of last resort.

Conditions in the financial system and management issues faced by financial institutions observed through on-site examinations and off-site monitoring are as follows.

1. Overview

There has been further progress in financial institutions' disposal of nonperforming loans (NPLs). The ratio of NPLs to total loans has continued to decrease. Financial institutions' profits have largely increased mainly due to a decline in credit costs (i.e., write-offs and loan-loss provisions for NPLs). In addition, their overall financial strength has been improving as some financial institutions have been raising more funds in capital markets. Under these conditions, financial institutions have been expanding credit at home and abroad and also seeking opportunities for new financial services and business by making cross-sectoral investments and business alliances. Meanwhile, financial institutions have been gradually making progress in advancing their management of risks and business activities although they still face some challenges. Moreover, there is room for further improvement in strengthening the profitability of their core business.

Details of the main findings of on-site examinations and off-site monitoring by major risk category are as follows.

2. Credit risk

On the whole, there have been further improvements in financial institutions' credit risk management and in the quality of loan portfolios.

Self-assessments by individual financial institutions of their exposure to credit risk have become more accurate, and the practice of conducting write-offs and setting aside loan-loss provisions in line with those assessments is taking hold. As for corporate restructuring, financial institutions including regional institutions have been making

Table
Number of Financial Institutions Examined in Recent Years

	Fiscal 2003	Fiscal 2004	Fiscal 2005
Domestically licensed Japanese banks	**50**	**46**	**42**
***Shinkin* banks**	**69**	**67**	**73**
Other institutions including securities companies and Japanese branches of foreign banks	**21**	**40**	**45**
Total	**140**	**153**	**160**

1. The fiscal year in Japan starts in April and ends in March.

continuous efforts, and these seem to be bearing fruit. Risk management at some financial institutions still needed improvement in the following areas: (1) assessment of borrower firms on a corporate-group basis and estimation of their future cash flows; (2) a gap between the estimated value of real estate taken as collateral and its actual disposal value, especially in the regional economy where land prices have been falling; and (3) review of corporate restructuring plans submitted by borrower firms and insufficient provision of advice with regard to actions laid out in the plans.

An increasing number of financial institutions have developed more reliable internal rating systems and have been quantifying credit risks based on such methods. The Bank, in its on-site examinations, quantified risks taken by financial institutions, which had already established such internal credit rating systems, and discussed the risk profiles of their credit portfolios and future credit costs. The Bank found that there was room for improvement, mainly at regional financial institutions, in terms of the performance of methods for internal rating and risk quantification. The Bank also found that there were still various management issues in utilizing methods, for example, for the allocation of risk capital under the integrated risk management framework and for the setting of lending rates corresponding to the borrowers' creditworthiness.

With regard to active credit portfolio management, some institutions such as major banks, which had almost finished the disposal of large NPLs, began to shift to more effectively controlling concentration in their overall credit portfolios, including performing loans with normal returns.

Financial institutions have become more willing to extend loans as constraints on capital have eased. Reflecting this tendency, lending rates have continued to decrease and new types of loans such as mortgages, uncollateralized loans to small and medium-sized businesses based on credit scores, syndicated loans, and non-recourse real estate loans, have been expanded. With regard to credit pools of small loans such as mortgages and uncollateralized loans to small and medium-sized businesses, the Bank through its on-site examinations found that there were some cases where improvement in risk assessment of such loans was needed by better grasping changes in borrower characteristics and sufficiently reviewing scoring models. As for syndicated loans and non-recourse real estate loans, the Bank found some problems with estimation of future cash flows, assessment of collateral values, and setting of covenants.

3. Market risk

Major banks have established methods for controlling risk within their integrated risk management framework. Throughout fiscal 2005, they generally maintained a cautious stance on investment with a view to containing the amount of interest rate risk within capital allocated, while at the same time they continued to enhance the accuracy of risk quantification methods.

Regional financial institutions, on the other hand, have generally expanded securities investment in order to improve their profitability, and it has therefore become all the more important for them to manage market risk properly. The Bank, however, found cases at quite a few financial institutions where risk management efforts were needed in terms of quantifying risks and setting risk limits in accordance with their capital adequacy.

All major banks have kept their stockholdings below the level of their Tier I capital, and they have almost completed curtailing their stockholdings. The risks associated with financial institutions' stockholdings have increased to some extent, as these institutions have stopped reducing their stockholdings and the volatility of the stock market has risen.

Many financial institutions have been increasing their investment in structured bonds, real estate funds, and hedge funds so as to achieve higher returns. The Bank examined the risk management frameworks associated with such investment using pricing models in some cases, and found that some financial institutions had problems related to establishing the principles for individual investment decisions and to confirming whether investment decisions comply with such principles, as well as to the identification and quantification of the associated risks.

4. Settlement and liquidity risks

Since the full removal of blanket guarantee of deposits at the beginning of fiscal 2005, neither a large shift in deposits nor trouble related to financial institutions' liquidity management has occurred. No serious problems have occurred with the payment and settlement operations of financial institutions, although some troubles associated with securities transactions have been observed. The Bank found through its on-site examinations, however, that there were some cases where financial institutions needed further improvement in monitoring the funding conditions, implementing stress analyses, drawing more detailed contingency plans, and carrying out practical drills, although they have not actually experienced any specific problems under the accommodative financial environment.

The market reputation of major banks, including their creditworthiness, greatly improved as their profits and financial strength recovered. Thus, their stance on domestic currency funding has returned to normal. Foreign currency funding has also been smooth, and there has been an active expansion of investment assets.

5. Operational risk[2]

The characteristics of financial institutions' operational risk have been changing greatly. On the one hand, financial institutions have been further automating and streamlining their operations by centralizing operations at their headquarters and increasing outsourcing. And, on the other hand, they have begun to take active steps to offer new financial services. The number of incidents, accidents, or other problems has been on an uptrend. In particular, cases involving large-scale embezzlement and leaking of confidential information came to light in fiscal 2005. Operational risk management has therefore become increasingly important. Financial institutions need to enhance internal control through efforts such as (1) implementing appropriate rules and manuals, (2) enforcing systems for checking and authorizing operations through staff training, and (3) enhancing the functioning of internal audits. Meanwhile, throughout fiscal 2005, various measures were taken to deal with new types of financial crimes such as counterfeit automated teller machine (ATM) cards or "phishing." Some financial institutions, however, were slow in implementing necessary measures.

There was a decline in the number of large-scale malfunctions of computer systems in fiscal 2005, despite the fact that large-scale system integration and joint system development and operation among two or more financial institutions were carried out. However, there were increases in the incidence of smaller system troubles causing customers inconvenience at regional financial institutions and their joint operational centers, and there were major system troubles arising from securities transactions. The Bank checked through its on-site examinations whether financial institutions' computer systems were being developed and run appropriately, and found that there was room for improving information security and management of third parties to whom they have outsourced operations (outsourcees).

There has been gradual progress in business continuity arrangements. However, the Bank found that there were still many financial institutions which needed improvement in establishing back-up facilities and in conducting emergency drills regularly.

II. On-Site Examination Policy for Fiscal 2006

A. Core Elements of the Bank's Policy on On-Site Examinations

The Bank will focus on encouraging financial institutions' efforts to improve their management of risks and business activities and to develop innovative services tailored to customer needs, thereby contributing to the enhancement of the functioning and robustness of the overall financial system. At the same time, the Bank will continue to ensure that it has an accurate grasp of the performance of financial institutions through its on-site examinations, so as to be ready to act as the lender of last resort.

Given the recent changes in the economic and financial situation, it is all the more important for financial institutions to manage risks and business activities with an emphasis on the future outlook, taking into consideration various uncertainties related to, for example, business performance in the corporate sector, market interest rates, and asset prices. The Bank will have in-depth discussions with each financial institution on management issues on this front, and support its efforts toward finding appropriate solutions.

Based on the above principles, the Bank will conduct its on-site examinations in fiscal 2006, with the following five points providing the core elements.

1. Assessing the economic value and risk associated with assets and financial transactions

Given the dynamic changes in the economic situation, it has become even more important for financial institutions to properly assess the whole range of their assets and financial transactions in terms of their economic value and volatility (i.e., risk) in order to control risks appropriately.

2. In this paper, operational risk covers risks that attend business operations in general including those related to computer systems and business continuity.

As for loan assets, the Bank will broadly apply the approach based on the discounted cash flow (DCF) method and work to develop a common understanding with financial institutions regarding the assessed economic value and risk involved in assets including new types of loans such as syndicated loans and non-recourse real estate loans. In doing so, the Bank will discuss with these institutions the process for setting lending rates and how they can better advise borrower firms to improve their financial conditions in cases where the economic value of these institutions' assets has decreased.

For financial institutions that have already established internal credit rating systems, the Bank will verify the accuracy of such systems. The Bank will also evaluate risks involved in credit portfolio concentration as well as the effects of the business cycle on the associated risks, and then discuss methods for controlling credit risk and setting lending rates, based on the quantification and analysis of expected losses (EL) and unexpected losses (UL) in financial institutions' credit portfolios.

With respect to credit pools of small loans, such as mortgages and uncollateralized loans to small and medium-sized businesses which financial institutions have been expanding, the Bank will examine how financial institutions have developed the systems for managing the associated risks on a collective basis. This will include compiling data such as borrower characteristics, portfolio monitoring, and setting lending rates.

Turning to assets other than loans, the Bank will assess the economic value of financial institutions' assets as follows: (1) assess the economic value of assets for which market prices are available, such as listed securities, by using the mark-to-market approach; and (2) assess the economic value of assets for which market prices are not available, for example, structured bonds, structured deposits and loans, privately placed real estate funds, and hedge funds in which financial institutions have invested increasingly, by utilizing pricing models, i.e., the mark-to-model approach, where necessary.

2. Developing and utilizing integrated risk management

It is important for financial institutions to develop an integrated risk management framework covering credit risk, market risk, and operational risk and to utilize it for their business management, when they review their capital adequacy, evaluate risks and returns on assets, and determine efficient capital allocations. This will help their business to become even more rational and efficient. In its on-site examinations, the Bank will encourage financial institutions to develop and utilize an integrated risk management framework, taking their specific financial and business conditions into consideration.

Specifically, the Bank will hold in-depth discussions on topics such as how to further improve methods for integrated risk management and how to utilize risk-adjusted indicators for business management, with financial institutions, particularly with major banks that have already been developing such risk management systems. Meanwhile, with respect to financial institutions that have not yet introduced an integrated risk management framework, the Bank will work together to develop a common understanding of integrated risk management. These points are consistent with the concept of the new capital adequacy framework, Basel II. The Bank will also support financial institutions' efforts to develop integrated risk management frameworks by encouraging them to collect necessary data and to establish measures to quantify risks.

Considering the possibility of future interest rate fluctuations, it is becoming increasingly important for financial institutions to appropriately control interest rate risk within an integrated risk management framework. In its on-site examinations, the Bank will carefully examine financial institutions' interest rate risk management systems. At the same time, the Bank will examine whether capital is being efficiently allocated and used, as a buffer for taking additional risks, based on factors such as changes in the economic value and risks associated with individual asset holdings. The Bank will also examine whether management decisions on investment strategies are being made through appropriate internal procedures based on the assessment of the associated risk in proportion to financial institutions' capital bases. In relation to interest rate risk, the Bank will also have in-depth discussions on the following: (1) awareness of the interest rate risk associated with banking account transactions such as deposits and loans; (2) the possibility of changes in asset and liability structure caused by interest rate fluctuations; and (3) the effects of such changes and measures for controlling interest rate risk.

Information disclosure by financial institutions, based on appropriate assessment of the economic value of their assets and the associated risks, will make it easier for depositors and investors to evaluate the management capabilities of financial institutions and to assess the corresponding risks and returns on their investments. This is expected to improve the functioning of market discipline on financial institutions' management. From this viewpoint, the Bank will encourage financial institutions to further improve information disclosure regarding their risk management.

3. Active credit portfolio management

If financial institutions acquired the ability to more objectively assess risks and returns on their assets under an integrated risk management framework, they would be able to control risks involved in credit portfolio concentration as well as overall risks and returns on their credits, and thereby optimize their credit portfolios through measures including active reshuffling of their assets. This would lead to increased activity in credit markets, such as markets for securitizing loans and other assets, and to more diversified channels for credit extension, and hence to the enhanced functioning of the entire financial system.

From this viewpoint, the Bank will, through its on-site examinations, support financial institutions' efforts toward active credit portfolio management and hold in-depth discussions with them on necessary measures, such as reviewing legal frameworks and business practices.

4. Ensuring smooth settlement and business continuity

Taking into consideration the probable change in the financial environment after the termination of the quantitative easing policy, financial institutions are expected to manage their liquidity more effectively and to implement their payment and settlement operations smoothly. In its on-site examinations, the Bank will identify risks inherent in the overall payment and settlement system and also carefully examine financial institutions' liquidity management, with a view to preventing the materialization of systemic risk.

The Bank will continue to monitor projects aimed at computer system integration and joint system development and operation among two or more financial institutions. The Bank will also verify the stability of such systems and the level of safety regarding information security, in light of factors such as changes in financial institutions' computer system structure and the technology that forms the basis for the structure. In addition, the Bank intends, where necessary, to check operators of clearing systems and financial institutions' outsourcees to ensure smooth operation of the overall payment and settlement system.

Financial institutions need to make further efforts to establish more extensive business continuity arrangements for emergencies, namely, natural disasters and terrorist attacks, where they will not be able to continue their normal business operations. Specifically, the Bank intends to hold in-depth discussions on establishing effective business continuity arrangements and coordination with the Bank with operators of clearing systems as well as financial institutions that have a strong presence in financial markets or that function as hub parties in the settlement system whose business disruptions would have a serious impact on financial markets.

5. Establishing internal controls

It is important that financial institutions have in place internal control systems and that they are functioning effectively, in order to achieve advanced risk management and efficient business management. Effectively functioning internal control systems are also essential in enhancing security in financial transactions by ensuring appropriate business operations and dealing with financial crimes.

The Bank will support financial institutions' efforts to establish internal control systems through its on-site examinations by giving due consideration to their specific financial and business conditions. Specifically, the Bank will identify risks associated with financial institutions' management and operations, examine the functioning of control activities such as segregation of power and responsibility as well as internal authorization procedures, and discuss the effectiveness of monitoring activities such as internal audits.

Based on the five core elements as outlined above, the Bank has prepared a list of key points by major risk category which it will focus on in its on-site examinations in fiscal 2006 (see Attachment).

B. Practical Issues Relating to On-Site Examinations

In conducting its on-site examinations in fiscal 2006, the Bank intends to maintain a close dialogue with management at financial institutions and jointly seek solutions for problems, so as to provide financial institutions with an opportunity to enhance their management of risks and business activities. In this process, the Bank will take measures to make effective use of the functions of off-site monitoring and the seminars hosted by the Center for Advanced Financial Technology. The Bank also intends, where necessary, to continue to exchange views regarding accounting issues with external auditors and financial institutions.

The Bank will continue to give due consideration to easing the burden of on-site examinations on financial institutions. Specifically, based on the "On-Site Examination Policy for Fiscal 2006," the Bank will further shift the focus of its on-site examinations from the assessment of individual assets to that of their risk management framework. Along with this shift, the Bank will reduce the number of samples extracted from financial institutions' overall loan portfolios based on the condition of their risk management. In addition, the Bank will take a more flexible approach to the scope and duration of on-site examinations, and the size of examination teams, depending on the financial and business conditions at each financial institution.

Furthermore, the Bank intends to make greater use of the online data exchange system so that data used in its on-site examinations and off-site monitoring can be exchanged more efficiently and safely. The Bank introduced in fiscal 2005 extensible business reporting language (XBRL) for exchanging financial data between financial institutions and the Bank. The Bank will expand the range of package data files collected through XBRL in order to make the exchange of financial data more efficient and to encourage the development of an advanced financial information network.

ATTACHMENT: KEY POINTS FOR ON-SITE EXAMINATIONS IN FISCAL 2006 BY RISK CATEGORY

Credit Risk

- Verify that economic value and volatility, i.e., risks, of the whole range of financial institutions' assets—that is, not just their loan assets—as well as their financial transactions are assessed properly, and that risk management is appropriately based on such assessments. Also examine whether financial institutions have in place internal control systems that ensure such risk management and whether they are functioning effectively.
  —Assess loan assets in terms of their economic value and associated risks, including new types of loans such as syndicated loans and non-recourse real estate loans, by applying broadly the approach based on the discounted cash flow (DCF) method.
  —Discuss the process for setting lending rates and how they can better advise borrower firms to improve their financial conditions, in cases where the economic value of financial institutions' assets has decreased.
  —As for credit pools of small loans, for example, mortgages and uncollateralized loans to small and medium-sized businesses, examine risk management systems for accumulating related data including borrower characteristics and discuss the process for setting lending rates.
  —Evaluate economic value of loan assets purchased from the credit market and review overall risk management systems with regard to trading of loans.
- Examine whether financial institutions have established systems to collect and check data that form the basis for internal credit rating systems. Also evaluate the accuracy of such systems, by looking at differences between estimates and actual records of default in the past. These points are consistent with the concept of the new capital adequacy framework, Basel II.
  —For financial institutions that have not yet introduced internal credit rating systems, work together to develop a common understanding of credit risk management practices and support their efforts to develop and utilize such systems by encouraging data collection, taking due account of financial and business conditions of individual institutions.
- For financial institutions that have already established internal credit rating systems, examine risks involved in credit portfolio concentration as well as the effects of the business cycle on the associated risk, and then discuss methods for controlling credit risk and setting lending rates, based on quantification and analysis of expected losses (EL) and unexpected losses (UL) of their credit portfolios.
  —Verify the adequacy of the various risk parameters on which the above estimate is based, by examining, for example, actual records of borrower default and collateral disposal, as well as assessment of borrower firms treated on a corporate-group basis.
- Develop a common understanding of active credit portfolio management with financial institutions, taking due account of their financial and business conditions. Also discuss the measures necessary to promote such active portfolio management including objective assessment of risks and returns on assets, appropriate review of legal frameworks and business practices, and enhancement of market infrastructure.
- Evaluate whether financial institutions properly assess the disposal value of pledged real estate, taking due account of records for auctions and discretionary sales of similar properties, financial institutions' stances with regard to disposal, and the results of on-site reviews of pledged real estate. Verify, where necessary, that financial institutions are appropriately assessing the value of real estate with soil contamination and other risk factors.

Market Risk

- Verify that economic value and volatility, i.e., risks, of the overall assets other than loans and financial transactions are assessed properly, and that risk management is appropriately based on such assessment. Also examine whether financial institutions have in place internal control systems that ensure such risk management, and whether they are functioning effectively.
- Examine how financial institutions assess and manage interest rate risk. Also verify that investment decisions are being made through appropriate internal procedures based on an objective assessment of the size of risks and expected returns, taking their capital bases into consideration.
  —Examine how financial institutions develop and operate asset liability management (ALM), considering the possibility of the changes in their asset and liability structure which may be caused by probable interest rate fluctuations in the future. Also discuss awareness of the estimated holding periods for demand deposits and the interest rate sensitivity of various assets and liabilities, as well as methods for estimating them.
  —Verify that financial institutions manage interest rate risk associated with mortgage lending in light of the characteristics of their credit portfolio, considering the possibility, for example, that borrowers will refinance with different products or make prepayments under various scenarios for the interest rate.
- As for such assets as structured bonds, structured deposits and loans, privately placed real estate funds, and hedge funds, verify systems for risk quantification and related risk management by type of product as well as the principles for individual investment decisions and associated internal procedures.
  —In examining systems for quantification and management of risks by type of product, confirm that financial institutions properly assess the economic value of each product, using pricing models where necessary.
- Review systems for the quantification and management of the risks involved in stock investment, by taking into account the holding period and the time needed to liquidate. Verify that investment decisions are being made through appropriate internal procedures based on the objective assessment of the size of risks and expected returns, taking individual financial institutions' capital bases into consideration.

Settlement and Liquidity Risks

- Examine whether financial institutions' awareness of settlement and liquidity risks takes adequate account of possible changes in the financial environment. Then, examine whether financial institutions have established appropriate risk management, and also have in place internal control systems that ensure such risk management, and whether they are functioning effectively.
  —Examine financial institutions' management of settlement and liquidity risks for both yen and foreign currencies based on stress analyses. Also examine the effectiveness of financial institutions' contingency plans in the event of funding difficulties.
  —Carefully examine the settlement and liquidity risk management of financial institutions which function as hub parties in the overall funds and securities settlement, or whose transactions are concentrated with only a few particular counterparties, so as to prevent systemic disruptions.

Operational Risk

(1) Operational risk associated with business operations

- Examine whether financial institutions, while restructuring their operational systems and proceeding to offer new financial services, have established appropriate business operations and risk management, and also have in place internal control systems that ensure such business operations and risk management and whether they are functioning effectively.
- Check, when necessary, outsourcees on site, when these are entrusted with core business operations, development and maintenance of computer systems, and handling of important certificates such as banknotes, bills, and other securities.
- Support financial institutions' efforts to achieve more advanced operational risk management by helping improve their systems for collecting and analyzing data for the quantification of risks, when they are making efforts in risk quantification such as planning to implement Advanced Measurement Approach (AMA) under the new capital adequacy framework, Basel II.

(2) Computer systems

- In order to ensure stable operation of payment and settlement systems, examine whether financial institutions have developed and are operating computer systems and risk management appropriately, and whether they have in place internal control systems that ensure such business operations and risk management, and whether they are functioning effectively.
- With respect to system integration and joint management of system development and operation by two or more financial institutions, examine whether financial institutions' computer systems are developed and run appropriately and also whether the institutions have in place contingency plans to respond appropriately in the event of system failures.
- With a view to ensuring stable operation of the payment and settlement system as a whole, examine, where necessary, whether operators of clearing systems are designing and operating their systems appropriately, as it is possible for risks to become concentrated at clearing systems.
- With the increasing prevalence of both open and network systems, verify that the development and operation of such systems are conducted appropriately by financial institutions, including monitoring of outsourcees.

(3) Business continuity arrangements

- With the aim of enforcing the business continuity capability of the financial system as a whole, examine whether each financial institution has established the necessary business continuity arrangements corresponding to the impact of its operational disruption on the financial system.
  —Examine business continuity plans from the following perspectives: (1) whether the risks which could cause operational discontinuity, such as natural disasters, system troubles, dysfunctions of public infrastructure, terrorist attacks, and pandemics have been identified; (2) whether crucial business operations which should be given priority in terms of business continuity have been specified, and whether an expected timetable for recovery has been drawn up; and (3) whether financial institutions' coordination with relevant external counterparties has been established.
  —Confirm that periodic drills and constant reviews of plans are conducted so as to maintain the effectiveness of business continuity arrangements.
  —Hold in-depth discussions, with operators of clearing systems as well as financial institutions which have a significant presence in financial markets or function as hub parties in the settlement system, regarding the establishment of more extensive business continuity arrangements.

(4) Security measures attending financial transactions

- Examine whether financial institutions have in place internal control systems and whether they are functioning effectively, including whether they have drawn up rules related to compliance, implemented effective training programs, and conducted internal audits, with a view to enhancing security in financial transactions by ensuring appropriate business operations and dealing with financial crimes.
- Verify that information security is managed adequately. Also examine whether protection of customer information is being handled appropriately in accordance with the relevant laws and regulations.
- Concerning sophisticated financial crimes, such as those involving the use of counterfeit cards, "phishing," and spyware, verify that management has decided its stance on these issues and that appropriate measures have been taken, while gathering the latest information in the field.

Financial Strength and Integrated Risk Management

- Review financial institutions' projections with respect to earnings and financial strength by conducting simulations based on expected risks and returns.
  —In doing so, evaluate the profitability of loan business on a credit cost deducted basis. Also assess the impact of future interest rate fluctuations on financial institutions' earnings.
  —Discuss how the economic value of deferred tax assets should be assessed and recorded on financial institutions' balance sheets, taking financial institutions' future profits and their volatility into account.
- To make integrated risk management more effective, discuss, taking due account of financial and business conditions of each institution, techniques for quantifying risk, categories of quantifiable risk, and utilizing these results in financial institutions' business management.
  —For financial institutions that have not yet introduced integrated risk management frameworks, work together to develop a common understanding of integrated risk management, taking due account of individual institution's financial and business conditions. These points are consistent with the concept of the new capital adequacy framework, Basel II. Also support their efforts to develop integrated risk management frameworks by encouraging them to collect necessary data and to establish measures to quantify risks.
  —Discuss the use of stress tests to manage financial institutions' business, where necessary.
- Review whether financial institutions' allocation of capital to business units and their assessment of each unit's profitability are being made in line with an integrated risk management framework.
- Discuss ways to improve disclosure of information, namely on risk management, the economic value of financial institutions' assets and associated risks, and the operation of integrated risk management.
- Discuss with financial institutions whether they are able to raise additional capital needed to, for example, finance new profit opportunities and repay public funds.
- Verify whether internal control systems have been in place and are functioning effectively to achieve management goals.
  —Identify risk profiles of financial institutions based on their internal environments for controlling, for example, business lineups, and verify the functionality of control activities including segregation of power and responsibility and internal procedures in line with associated risks. Also examine whether monitoring activities such as internal inspections within each branch and internal audits are conducted appropriately.

Financial Markets Report (Summary)

The full text in English can be accessed at the Bank's web site (http://www.boj.or.jp/en/index.htm).

Summary[1]

A. Financial Market Developments during the Second Half of 2005

During the second half of 2005 in Japanese financial markets, (1) stock prices have moved out from their recent trading range and risen strongly relative to overseas markets, (2) long-term interest rates have risen moderately, and (3) the yen has tended to fall against major currencies. Growing confidence in Japan's economic recovery has contributed to the rise in stock prices and active investment in other financial assets.

In the interest rate markets, while the year-on-year change in the consumer price index turned to zero from small negative figures, prospects of an end to the quantitative easing policy and subsequent rise in interest rates have become clearer, leading to a rise in short- to medium-term interest rates. On the contrary, the rise in long-term yields has been small and the rate remained below the yearly high of 2004.

In the equity markets, the Nikkei 225 Stock Average rose to 16,000 yen, the highest since October 2000, as the recovery in the economy and solid corporate earnings were confirmed. Stock indexes of newly developing markets were also at historical highs, and both the volume and value of transactions surpassed the level during the bubble in the 1980s to reach historical highs. Overseas investors continued to purchase Japanese stocks actively, and the base of investors expanded as more individual investors utilized Internet trading and margin trading. Firms' share buybacks and M&As have increased as well.

Credit spreads have been stable at tight levels on the whole as investors' demand for credit products such as corporate bonds remained strong and their search for yield continued against the background of improved corporate earnings and the low interest rate environment. Under this favorable financing circumstance, signs of firms' accelerating financing activities are observed as the year-on-year change in the amount outstanding of lending by private banks, after adjustment for extraordinary factors, turned positive in the second half of 2005, and the amount of CPs and corporate bonds issued increased. During the period, firms across different sectors started to borrow and new credit channels have steadily broadened as markets for securitized products and syndicated loans continued to develop.

In the foreign exchange markets, the yen fell against major currencies as well as against Asian currencies. The yen had fallen against the U.S. dollar to 121 yen by the beginning of December 2005, the lowest level since March 2003, then rose toward the end of the year, but it remains well below the level in the first half of the year 2005.

The notable factors affecting Japanese financial market developments are as follows: (1) the rise in long-term interest rates was small due to the subdued expectations for inflation in Japan and abroad; (2) investors' search for yield continued under the low interest rate environment, thus affecting the pricing of assets resulting in, for example, the rise of stock prices; and (3) the interest rate differential between Japan and abroad widened as the United States, euro area, and other areas raised their interest rates. These changes have encouraged domestic investors, including individual investors, to expand their investments in foreign financial assets.

From a global perspective, Japan's situation was not unique. Stock prices rose in the United States, Europe, and elsewhere, while long-term interest rates remained relatively stable. Investors' search for yield has been widely observed in the global financial markets. Investors placed their funds actively not only in equity and credit markets but also in hedge funds and commodity markets. Under this trend, overseas investors continued to increase their holdings of Japanese stocks in their portfolios, supporting the vigorous rise in Japan's stock prices. Regarding Japanese government bonds (JGBs), although the share of holdings by overseas investors has been still limited, overseas investors have a growing presence in the JGB futures market and other related markets. Consequently, the correlation between long-term Japanese interest rates and the U.S. rates has strengthened. Outward investments by domestic investors were led by various investors and investment channels, such as foreign bond purchases by institutional investors, foreign asset purchases through mutual funds by financial institutions and individual investors, and foreign exchange margin transactions by individual investors. These capital flows, coupled with the reduced trade surplus associated with higher crude oil prices, drove the yen lower.

1. The original version in Japanese was published in January 2006.

B. The Issues on Functions of Financial Markets and the Bank's Initiatives

With a view to improving the functions and efficiency of financial markets, the Bank conducts market research and takes initiatives to facilitate the market infrastructure. The major issues up to fiscal 2006 are the following.

1. Short-term money markets

Under the Bank's quantitative easing policy, the amount of transactions in short-term money markets has been reduced drastically. Depending on economic conditions and financial developments in the coming months, the behaviors of market participants could change further, and short-term money markets may well be required to restore more efficient intermediary function accordingly. Meanwhile, various structural changes have occurred in environments surrounding short-term money markets, for example, lenders and borrowers in the markets have changed as financial institutions have been consolidated and their balance-sheet structure has changed. Moreover, the fluctuation of intraday fund positions has become greater following the introduction of real-time gross settlement (RTGS). Therefore, there are many issues to be addressed to restore the functions of short-term money markets. The Bank will continue to discuss with market participants issues such as the changing behavior of market participants with respect to funding operations and management of interest rate risk and the resultant effects on money markets. The Bank also seeks joint efforts with market participants to identify further challenges to be addressed in order to attain improved market functioning.

2. Credit markets

During the period from 2002 to 2003, when the intermediary function of Japanese financial institutions was constrained, the Bank implemented temporary measures, including establishment of outright purchase operations of asset-backed securities (ABSs) and asset-backed CPs (ABCPs), with a view to supporting the ABS and ABCP markets that were still in their infancy. Since then, the ABS market has developed steadily, and so the purpose of these temporary measures to support the ABS market is considered to be largely accomplished. In addition, the environment surrounding corporate financing has improved substantially since the temporary measures were implemented. The Bank therefore announced that it would terminate the temporary measures at the end of March 2006, as scheduled. The Bank considers that the development of new credit channels, such as ABS, syndicated loans, and credit derivatives remains to be critical to improve the efficiency and stability of the whole financial intermediary system in Japan. The Bank will, therefore, continue to closely monitor the development of credit markets by exchanging views with market participants and search for new tasks to be tackled. It will also continue to take initiatives in addressing outstanding issues such as the development of secondary markets and improvements in disclosure and buildup of market data. Meanwhile, the Bank has embarked on taking actions to facilitate the use of credit market related instruments as collateral in transactions with the Bank.

3. Business continuity plan

The 9.11 terrorist attacks in 2001 drove global market participants and related parties strongly to recognize that it is essential to develop a business continuity plan (BCP) for maintaining market functioning in case of disaster. Indeed, it is now a widely shared notion that BCP is an integral part of market infrastructure that retains minimal market functioning in times of disaster. Not only is BCP in the interest of each market participant but also contributes to maintaining the stability of financial markets and the economy as a whole. It is necessary to secure networks in markets, including human networks among the related parties and alternative communication tools, in order to continue market transactions. The Bank has participated in discussions in each market and supported their BCP initiatives. The Bank will continue to promote and support concrete actions such as facilitating cooperation between markets, and assisting the building and operation of BCP-designated web sites.

Payment and Settlement Systems Report (Outline)

The full text is available only in Japanese and can be accessed at the Bank's web site (http://www.boj.or.jp).

Outline of the 2005 Issue of the "Payment and Settlement Systems Report"

A. Changes in the Financial Environment

Payment and settlement systems are an important part of the infrastructure supporting a nation's economic activity. Economic activity, such as commercial and financial transactions, can occur smoothly only if there is a high degree of confidence in the integrity of settlement. A failure of payment and settlement systems to function smoothly could have a significant impact on overall economic activity.

The Bank of Japan plays a number of roles in payment and settlement systems. As a provider of means of payment and an operator of payment and settlement systems, the Bank issues banknotes and provides funds transfer services via financial institutions' current accounts held at the Bank. In securities settlement, the Bank operates the Japanese government bond (JGB) book-entry system and the JGB registration system. The Bank oversees Japan's payment and settlement systems in order to promote their safety and efficiency, and also participates in cooperative oversight of cross-border or multicurrency payment and settlement systems with other central banks concerned. In July 2005, the Bank established the Payment and Settlement Systems Department with a view to contributing further to the development of safe and efficient payment and settlement systems.

From the 1980s onward, steady progress has been made in the reform of Japan's payment and settlement systems. In 1980s, given a surge in the number of financial transactions, online communication networks and automated processing of settlement instructions were introduced in the payment and settlement systems. In the 1990s and early 2000s, risk reduction measures were introduced and extensively enhanced in response to growing concerns about the stability of the financial system.

Changes in Japan's financial environment surrounding payment and settlement systems have been significant. Given the constant advances in information and communication technology, operators of and participants in payment and settlement systems are facing challenges in the area of information security. The market for payment and settlement services is undergoing structural changes such as increased "tiering," concentration, and internalization of settlement activities, as a result of the diversification of market participants and financial products, and an increase in cross-border and multicurrency financial transactions. In addition, there is an increasing awareness of the importance of business continuity planning to address a wide range of scenarios, including natural disasters and large-scale terrorist attacks.

Operators of and participants in payment and settlement systems are responsible for enhancing the safety and efficiency of Japan's payment and settlement systems, taking into account such changes in the financial environment surrounding payment and settlement systems.

In the "Payment and Settlement Systems Report," the Bank reviews Japan's payment and settlement systems in light of the changing financial environment. Based on the review, the Bank identifies the issues that need to be addressed.

B. Outstanding Issues

The following are issues that need to be addressed further, ongoing and future initiatives on those issues, and the Bank's role in further improving the safety and efficiency of Japan's payment and settlement systems.

1. Next-generation RTGS project

The safety of large-value payments in Japan improved significantly in the late 1990s and early 2000s. Various arrangements for risk management were implemented in deferred net settlement (DNS) systems operated by the private sector. The BOJ-NET Funds Transfer System (BOJ-NET FTS), operated by the Bank, was converted to a full-fledged real-time gross settlement (RTGS) system in January 2001.

Meanwhile, progress in information and communication technology has made it possible for payment systems to reduce risk while requiring less liquidity. Such innovative payment system designs have been implemented in many countries. Similarly in Japan, there is room to further enhance the safety and efficiency of the settlement of large-value payments.

In light of these changes, in November 2005 the Bank announced its proposal for the next-generation RTGS (RTGS-XG) project. Following public consultation, in February 2006 the Bank decided to implement the project and started the system development process. The project consists of two measures. First, the Bank will introduce liquidity-saving features (LSF) into the RTGS mode of the BOJ-NET FTS. Second, the Bank will modify the BOJ-NET FTS to incorporate large-value payments that are currently handled by two private-sector DNS systems—the Foreign Exchange Yen Clearing System (FXYCS) and the

Zengin System—into the new BOJ-NET FTS with LSF. With the implementation of the RTGS-XG project, participants will be able to reduce the amount of funds and collateral needed for settlement, while achieving intraday finality through RTGS. This will greatly enhance the safety and efficiency of the settlement of large-value payments in Japan.

The Bank plans to introduce LSF into the BOJ-NET FTS and incorporate payments handled in the FXYCS into the new BOJ-NET FTS with LSF during fiscal 2008. The Bank plans to incorporate large-value payments handled in the Zengin System into the new BOJ-NET FTS with LSF in around 2011.

In implementing the RTGS-XG project, the Bank will continue to cooperate closely with relevant parties including system participants and the Tokyo Bankers Association, the operator of the FXYCS and the Zengin System. For example, the Bank intends to support private-sector initiatives in reviewing market practices to adapt to the next-generation RTGS.

2. Risk management in private-sector DNS systems

Risk management in DNS systems operated by the private sector has been significantly strengthened from the late 1990s onward. For example, the FXYCS and the Zengin System have introduced credit exposure limits, loss-sharing rules, and liquidity-provision arrangements.

Operators of and participants in payment and settlement systems need to identify various risks that may arise in the system and ensure that the system rules and procedures can effectively manage those risks. In doing so, it is particularly important that the risk management arrangements be maintained and further strengthened based on the self-discipline of the operator and participants, even under the current deposit insurance framework which fully protects interbank settlement obligations arising from customer transfers.

It is also important that payment systems remain robust, and achieve international best practices where applicable, in light of changes in the market structure for payment services. For example, mergers in the financial sector and an increase in cases of outsourcing payment activities involving large financial institutions have led to a greater concentration of payment flows to a smaller number of participating financial institutions. As a result, in the Zengin System, some participants have set higher intraday credit exposure limits for ensuring smooth processing on peak settlement days. In such cases, the system has required those participants to post additional collateral to cover the additional exposure. The system may also need to raise the total amount of liquidity available under its liquidity-provision arrangement, in order to ensure the timely completion of daily settlements in the event of an inability to settle by the two participants with the largest individual settlement obligations.

The Bank will continue to support initiatives taken by private-sector payment systems to maintain and further strengthen their risk management arrangements.

3. Reform of securities settlement systems

Steady progress has been made in the reform of Japan's securities settlement systems. Full dematerialization was achieved for JGBs, CP, and other debt securities, with the establishment of a comprehensive legal framework applicable to all types of securities. Progress has also been made in the implementation of the delivery-versus-payment (DVP) mechanism and straight-through processing (STP), a seamless integration of systems and processes to automate the trade process from trade execution to settlement.

Priorities for further improvement would be the realization of full dematerialization for beneficiary certificates of investment trusts and stocks as scheduled, and the start of substantial discussions about remaining issues, which were identified during the review of securities settlement systems on the basis of internationally recognized standards, such as the shortening of settlement cycles for JGB transactions (i.e., the achievement of T+1 settlement).

In furthering the reform of Japan's securities settlement systems, it is vital to improve securities settlement infrastructures that are the foundation of the reform. In this regard, given the recent surge in the number of transactions at securities exchanges, it is important to set up a framework to ensure the smooth functioning of securities clearing and settlement systems and a rapid recovery from computer system malfunction.

The Bank will continue to support the reform of Japan's securities settlement systems by expanding the use of DVP and STP by linking its BOJ-NET FTS with various securities settlement systems. The Bank will closely monitor the developments in securities settlement infrastructures from various aspects including their operational reliability.

4. Foreign exchange settlement risk

Overall, foreign exchange settlement risk has been reduced. The volume and value of foreign exchange transactions settled in the Continuous Linked

Settlement (CLS) system have continued to increase since the system's launch in 2002. CLS eliminates principal risk in the settlement of foreign exchange transactions by settling the two relevant currencies on a payment-versus-payment basis.

In order for CLS to continue to function as an effective mechanism for reducing foreign exchange settlement risk, it is important for it to maintain stable operation in accordance with strict procedures for managing the risks that arise in the course of its settlement process.

When financial institutions settle foreign exchange transactions outside CLS, they need to operate under strict procedures for managing credit exposures that may arise due to the time lag between the settlements of the two currency legs.

As part of the ongoing effort to reduce foreign exchange settlement risk, the Bank and other central banks will carry out, during the second quarter of 2006, a survey on how banks and other financial institutions manage risks they may incur in settling foreign exchange transactions.

5. Cooperative oversight of international payment and settlement systems

Reflecting the globalization of financial markets, cross-border payment and settlement systems and service providers such as CLS and Society for Worldwide Interbank Financial Telecommunication (SWIFT) are expanding their business.

The Bank will continue to oversee CLS and SWIFT in cooperation with other central banks concerned to ensure that CLS and SWIFT have appropriate risk control mechanisms and robust business continuity plans.

6. Information security of bank account access services

Operators of payment systems and financial institutions are facing new challenges in the area of information security. With the expansion of automated teller machine (ATM) networks and the introduction of online banking via the Internet, the range and availability of bank account access services have expanded. In these circumstances, banks are confronting an increasing number of fraud cases involving unauthorized access to such accounts. Such fraud cases include illegal cash withdrawals using stolen or forged ATM cards and phishing attacks.

Vulnerabilities in information security could undermine public confidence in payment instruments and in the payment system as a whole. Financial institutions and operators of payment and settlement systems therefore need to make a strong commitment to implement sufficient security measures.

The Bank will make further efforts to raise the overall level of information security in the financial services industry. For example, the Bank will continue to conduct research on innovative security solutions, exchange information with experts, and discuss information security issues with financial institutions through interviews, on-site examinations, and other activities. As the secretariat of the Technical Committee on Financial Services of the International Organization for Standardization (ISO/TC68), the Bank will make further contributions to the establishment of international standards in this area.

7. Business continuity planning

In Japan, financial institutions and operators of payment and settlement systems have traditionally taken steps to prepare for emergencies such as earthquakes and other natural disasters. Nevertheless, there appears to be an increased threat of events of a different nature and impact, such as terrorist attacks and the outbreak of severe acute respiratory syndrome (SARS) and avian flu.

Strengthening the resilience of the Japanese financial system requires individual and cooperative efforts by financial institutions and operators of payment and settlement systems. Individual entities need to develop effective business continuity plans in order to ensure that they will be able to continue their critical operations, including settlement operations, in the event of a disruption. Given the nature of the financial system network, the relevant entities also need to cooperate and coordinate with each other in order to minimize the systemic effects of a disruption. Examples of coordination mechanisms include developing communication protocols and clarifying the roles played by different entities in the event of operational disruption. Industry-wide tests also need to be further enhanced to verify the effectiveness of coordination mechanisms.

The Bank will make further efforts to strengthen the resilience of the Japanese financial system. As the operator of the BOJ-NET FTS and BOJ-NET JGB Services, the Bank has already put in place various business continuity arrangements, including backup facilities in Osaka and joint tests with system participants. The Bank will further enhance these arrangements. Through interviews, on-site examinations, and other activities, the Bank will promote business continuity planning at financial institutions and payment and settlement systems. The Bank will also support private-sector initiatives to develop market-wide arrangements.

Japan's Balance of Payments for 2005 (Summary)

The full text in English will be made available on the Bank's web site (http://www.boj.or.jp/en/index.htm).

Summary

A. Overview

Japan's balance of payments (BOP) in 2005[1] recorded a current account surplus of 18.0 trillion yen, a small decrease from the surplus of 18.6 trillion yen in 2004.[2] The capital and financial account turned from a net inflow of 1.7 trillion yen in 2004 to a net outflow of 14.0 trillion yen in 2005.[3] Reserve assets increased by 2.5 trillion yen, which was a smaller increase than the one recorded in 2004 (17.3 trillion yen). Highlights of developments in the BOP are as follows.

B. Highlights of Japan's BOP for 2005

1. A decrease in the surplus in the balance of goods

The surplus in the balance of goods decreased for the first time since 2001. An increase in exports, in particular to Asia and the United States, was more than offset by a sharp increase in imports, reflecting higher prices for mineral fuels (crude oil and partly refined oil).

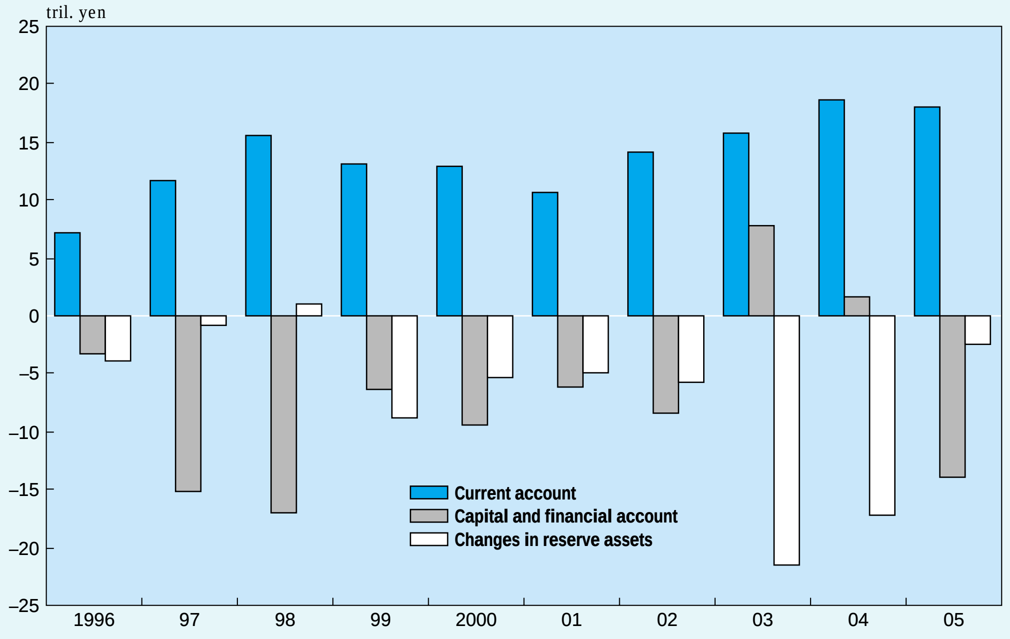
2. An increase in the surplus in the balance of income

The surplus in the balance of income increased for the third consecutive year. Principal contributing factors were an increase in portfolio investment income reflecting an increase in outstanding amounts of outward investment in bonds and notes, and higher U.S. interest rates. As a result, the surplus in the balance of income exceeded the surplus in the balance of goods for the first time since 1985, the first year for which comparable historical time series data are available.

3. A shift to net outflow in the capital and financial account

The capital and financial account recorded a net outflow for the first time in three years, and the level of outflow was the highest since 1998. This was mainly due to an increase in net outflow of direct investment, an increase in outward portfolio investment (outward investment in bonds and notes), and a shift to net outflow in other investment (repayment of funds brought in for conversion to yen).

Chart 1
Developments in the Balance of Payments



1. Data for the whole of 2005, the second half of 2005, and the fourth quarter of 2005, as well as the charts are preliminary unless otherwise stated. Annual, semiannual, and quarterly data in this report, including the charts, are on a calendar-year basis unless otherwise stated.
2. Figures until 2004 reflect changes made in the recording method of sea freight fares.
3. An increase in assets in the capital and financial account represents a capital outflow (increase in assets) in the BOP.

Chart 2

Japan's Balance of Payments for 2005

bil. yen

	2003	04	05	Changes from the previous year	Highlights
Current account	15,766.8	18,618.4	18,047.9	–570.5	Decrease in the surplus, mainly due to increased imports
Goods and services[1]	8,355.3	10,196.1	7,602.7	–2,593.5	Decrease in the surplus, mainly due to increased imports
Goods	11,976.8	13,902.2	10,350.2	–3,552.0	Sharp increase in imports due to higher mineral fuel prices
Exports	51,934.2	58,295.1	62,633.1	+4,338.0	
Imports	39,957.5	44,392.8	52,282.9	+7,890.0	
Services	–3,621.5	–3,706.1	–2,747.5	+958.6	Other services turned to surplus
Income	8,281.2	9,273.1	11,359.5	+2,086.4	Increase in portfolio investment income
Current transfers	–869.7	–850.9	–914.3	–63.4	Increase in tax payments to oil producing countries
Capital and financial account[2]	7,734.1	1,737.0	–13,957.5	–15,694.5	
Outward direct investment	–3,338.9	–3,348.7	–5,049.7	–1,701.0	Active outward direct investment
Inward direct investment	733.2	845.6	318.1	–527.5	Increase in both inward investment and withdrawal
Outward portfolio investment[3]	–18,396.1	–20,020.1	–23,657.3	–3,637.2	Increase in net purchases due to the purchase of long-term bonds by investment trusts such as monthly-distribution-type funds that invest in foreign bonds
Equity securities	–686.6	–3,290.3	–2,543.9	+746.4	
Bonds and notes	–18,392.7	–17,399.0	–22,110.7	–4,711.7	
Money market instruments	683.2	669.2	997.2	+328.1	
Inward portfolio investment[3]	9,532.9	21,899.3	20,345.0	–1,554.3	Decrease in net purchases (inflow) due to redemption (outflow) of money market instruments purchased in the previous year
Equity securities	9,838.6	10,595.8	13,955.2	+3,359.3	
Bonds and notes	–1,645.8	6,409.0	7,247.3	+838.3	Increase in purchases of equities and bonds and notes (including inflation-indexed JGBs)
Money market instruments	1,340.1	4,894.4	–857.5	–5,751.9	
Financial derivatives	607.4	259.0	–765.2	–1,024.2	Increase in payments related to margin trading in stock futures
Other investment[3]	19,006.3	2,649.3	–4,785.4	–7,434.7	Repayment of funds converted to yen by foreign banks
Changes in reserve assets[4]	–21,528.8	–17,267.5	–2,456.2	+14,811.2	No foreign exchange operations during 2005
Errors and omissions	–1,972.2	–3,087.9	–1,634.2	+1,453.7	
Ratio of current account to nominal GDP	3.2	3.8	3.6	—	

Notes: *1.* Goods and services reflect changes made in the method of recording sea freight fares.
2. Negative figures represent capital outflow.
3. Figures for portfolio investment and other investment exclude securities lending transactions.
4. Negative figures in "Changes in reserve assets" represent increase in reserve assets.

Chart 3
Developments in the Current Account

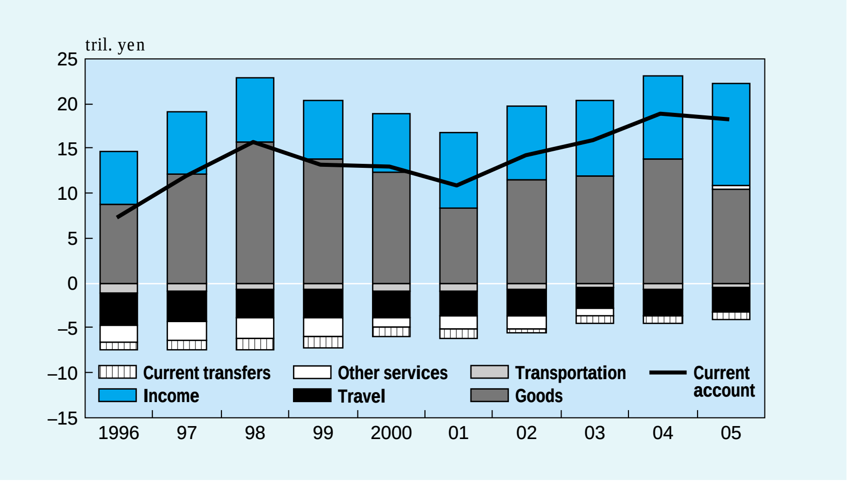


Chart 4
Developments in Outward and Inward Direct Investment

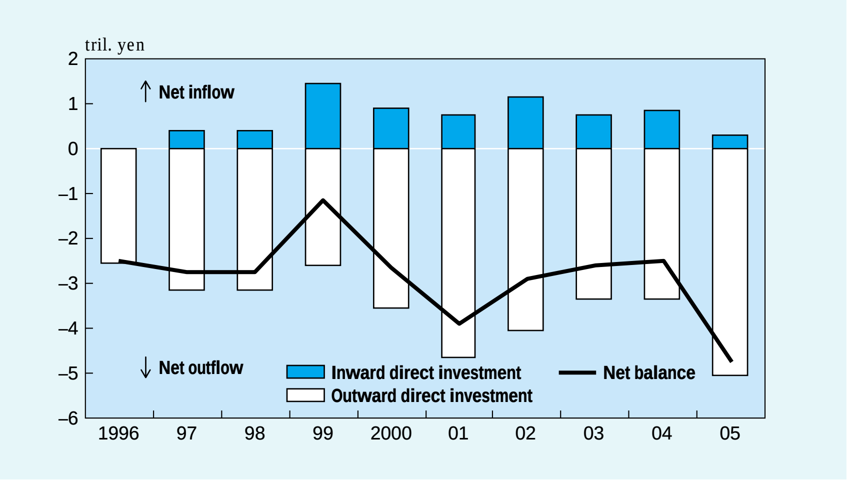
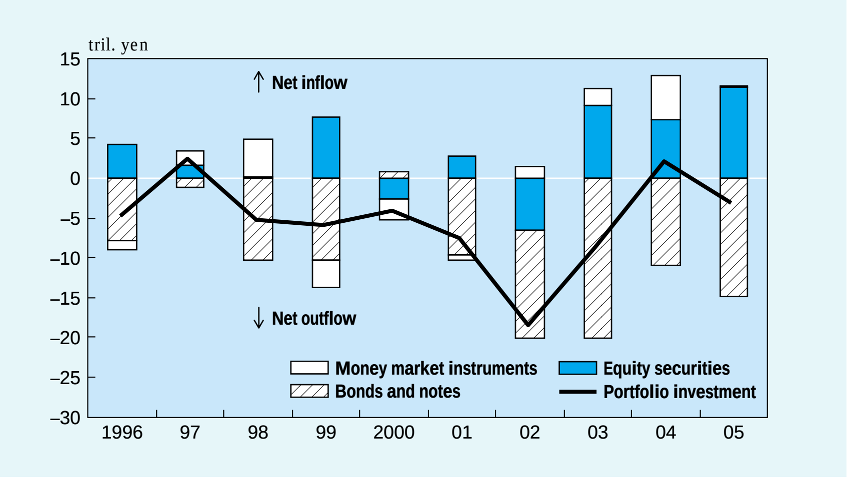


Chart 5
Developments in Outward and Inward Portfolio Investment



Recent Developments in Hedge Funds (Summary)

The full text in English will be made available on the Bank's web site (http://www.boj.or.jp/en/index.htm).

Summary

Definition of Hedge Funds

Hedge funds are becoming increasingly prominent in global financial markets. Although hedge funds and investment trusts are both forms of pooled investment vehicles, hedge funds are characterized by greater freedom for investment managers in terms of investment strategies. This is because hedge funds' investor base is limited to institutional investors and high net worth individuals, exempting them from the constraints of various regulations, and because they commonly place restrictions on investors' withdrawal of funds.

Growth of the Hedge Fund Industry and Changes in Risk Characteristics

Since the 1990s, the hedge fund industry has grown both in asset size and in number of funds. Investments in hedge funds by institutional investors have increased markedly since 2002. In Japan, pension funds and financial institutions, in particular, have increased investments in hedge funds. Such increase in investments into hedge funds has been supported by a low interest rate environment in major economies and by an increase in demand from investors to diversify their assets. Analyses using publicly available data, although there are some data constraints, reveal that in recent years (1) hedge funds produced positive returns regardless of stock and bond market performance; (2) volatility of hedge fund returns was lower than that of stocks; and (3) portfolio diversification could be expected from investing in hedge funds, as the correlation of returns between hedge funds and traditional assets was low. Such risk-return properties of hedge funds may have matched investor demand.

Hedge funds have become increasingly active in a variety of markets, exploiting new investment strategies as they grow in size and investor base, and have contributed to enhancing efficiency and liquidity in global financial markets. Accordingly, the risk characteristics of hedge funds have changed. Data show that in the few years after 2002, compared to the late 1990s, which coincided with the Long-Term Capital Management (LTCM) crisis, (1) returns of hedge funds and their volatility were lower and (2) incidents where hedge funds incurred large losses that exceeded maximum losses calculated by Value at Risk (VaR) were fewer. Meanwhile, investors have become more conscious of risk management and less keen on investing in hedge funds that use extraordinary levels of leverage, and leverage levels taken by hedge funds seem to have declined. Investors are also more careful to avoid concentrating their investments in certain hedge funds because hedge funds tend to be quickly weeded out in terms of "survival of the fittest."

Regulatory Environment in the Hedge Fund Industry

In the United States, the Securities and Exchange Commission (SEC) amended regulations to place tighter restrictions on investment managers. In the United Kingdom, a new collective investment vehicle that has the characteristics of hedge funds, called the Qualified Investor Schemes, was introduced for institutional investors. In some European and Asian countries, building a legal environment to allow hedge funds to target retail investors has been contemplated in recent years. Although the directions of changes are not uniform, legal developments with respect to hedge funds have been noted. These changes are all being made to find the appropriate balance between ensuring a wide range of investment options for investors and protecting investors.

Recent Issues concerning Hedge Funds

Hedge funds, on the whole, seem to be taking less risk in recent years. However, there are some that take high risk, and when the global financial environment permits, more funds may be inclined to do so in seeking higher returns. Given their growing presence in the global financial markets recently, it cannot be denied that large losses by or default of hedge funds may not only affect their counterparties and investors, but also have wide-ranging external effects on liquidity and the price discovery process in global financial markets. Therefore, it is vital to pay close attention to hedge fund activities and their effects.

In the discussion of hedge fund developments in global financial markets, two issues come to the fore: (1) exploring ways to enhance information disclosure on hedge funds and risk management by counterparties and investors of hedge funds; and (2) understanding the influences that hedge fund activities or default have on global financial markets and systems.

While there are outstanding issues to be addressed, much progress has been noted in risk management by counterparties of hedge funds since the LTCM crisis. However, it is necessary to

continuously check counterparties' risk management standards so that they will not be lowered when the environment becomes more competitive. The widely held view in regard to information disclosure on hedge fund activities is that having counterparties and investors obtain necessary information to manage risk from hedge funds is more efficient and effective than uniformly imposing statutory requirements on hedge funds.

Hedge fund activities and their influences need to be monitored, even though there are data constraints, with a focus on the following two issues in particular. One is whether there is a risk that hedge fund activities might destabilize markets if hedge fund transactions become concentrated on similar strategies or pressured to use high-risk strategies in market environments where profit opportunities are few. The second is whether there is a risk that market liquidity might dry up with the exit of hedge funds.

In these circumstances, financial authorities including central banks have been examining risk management systems of financial institutions including banks and securities firms, from the perspective that these market players are counterparties and investors of hedge funds. Furthermore, financial authorities have been discussing ways to adequately monitor market developments in hedge funds, such as enhancing information exchange in international fora and supporting efforts to improve databases on hedge funds.

Public Statements by the Bank of Japan

January–March 2006

January 10, 2006
Bank of Japan

Introduction of a DVP Mechanism for Settlement of Dematerialized Corporate Bonds

In Japan, most of the corporate bonds, municipal bonds, government-guaranteed bonds, *samurai* bonds, etc., (hereafter collectively referred to as Corporate Bonds) were issued in the form of registered securities under the Corporate Bonds registration system; however, the registration system involved some inconveniences. For instance, securities were registered at a large number of registrar banks, and securities transfers involved complex procedures.

To address these inconveniences, the Law Concerning Book-Entry Transfer of Corporate and Other Debt Securities was enforced in January 2003, establishing the legal framework for the full dematerialization of Corporate Bonds. Under the law, Japan Securities Depository Center, Inc. (JASDEC) was entrusted with the role of an operator of the book-entry transfer system for dematerialized Corporate Bonds, and started system operations today. The Bank of Japan (hereafter the Bank) took measures necessary for the introduction of a real-time delivery-versus-payment (DVP) mechanism for settlement of dematerialized Corporate Bonds,[1] such as establishing a link between the BOJ-NET Funds Transfer System and JASDEC book-entry transfer system for Corporate Bonds. With the introduction of the book-entry transfer system for Corporate Bonds, the Bank started BOJ-NET funds transfer services for DVP settlement of Corporate Bonds today. In addition, the Bank revised the DVP mechanism for dematerialized commercial paper (CP), originally introduced in March 2003, in line with the DVP mechanism for dematerialized Corporate Bonds.

Furthermore, the Bank started to accept dematerialized Corporate Bonds as eligible collateral for its various credit operations, and made it possible to post or return these bonds as collateral on an online basis through the BOJ-NET credit and collateral management system.

The Bank believes that the full dematerialization of Corporate Bonds and the introduction of DVP settlement will contribute greatly to the enhancement of the safety and efficiency of Corporate Bonds settlement and eventually to the development and expansion of the Corporate Bonds market. The Bank, in cooperation with relevant parties, continues to actively support further improvement of securities settlement systems in Japan.

1. DVP is a link between a securities transfer system and a funds transfer system that ensures that delivery occurs if, and only if, payment occurs. In the real-time DVP mechanism, both securities and funds transfers take place on a real-time gross basis.

February 3, 2006
Bank of Japan

Framework for the Next-Generation RTGS Project of the BOJ-NET Funds Transfer System[1]

The Bank today decided to implement the next-generation real-time gross settlement (RTGS-XG) project. The project consists of two measures with a view to further enhancing the safety and efficiency of large-value payment systems in Japan. First, the Bank will introduce liquidity-saving features into the RTGS mode of the BOJ-NET Funds Transfer System. Second, the Bank will modify the BOJ-NET Funds Transfer System in order to incorporate large-value payments that are currently handled by two private-sector deferred net settlement systems into the new RTGS system with liquidity-saving features.

The Bank also released today a document titled "Framework for the Next-Generation RTGS Project of the BOJ-NET Funds Transfer System." The document describes the framework for the RTGS-XG project and the Bank's responses to the comments received from public consultation.

Prior to the Bank's decision today, the Bank released a consultation document about its proposal on the RTGS-XG project on November 29, 2005, and requested comments from interested parties. The comments indicated wide support for the Bank's proposal. The framework of the project is unchanged from that proposed in the consultation document.

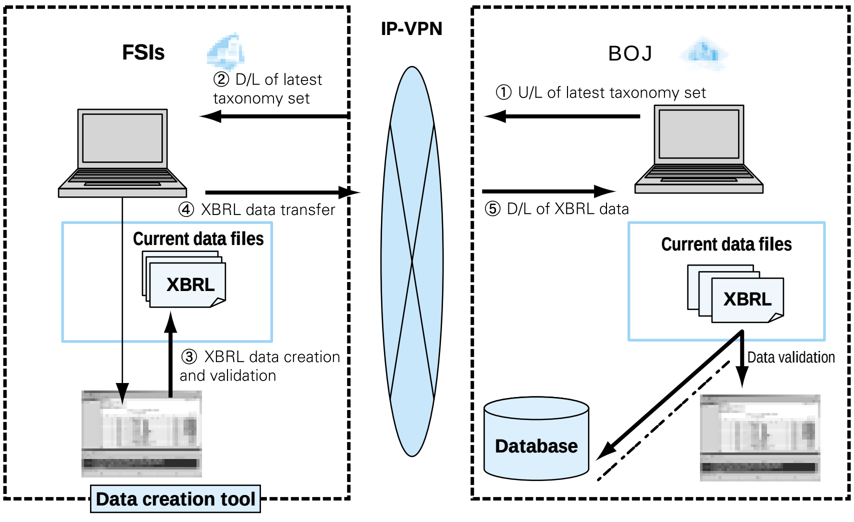
1. Documents mentioned in the text and the comments received are available in Japanese only, on the Bank's web site.

February 8, 2006
Bank of Japan

Implementation of XBRL for Financial Data Reporting

The Financial Systems and Bank Examination Department of the Bank of Japan has developed a new data transfer scheme based upon the latest XBRL[1] technology, in order to improve the efficiency of gathering data from financial institutions. The system has now been installed and is going live from today. Initially, the system will gather monthly B/S[2] data, then the range of data collected will be expanded gradually.

Image of data transfer using XBRL[3]



For further information, please contact:
E-mail: post.bsd5@boj.or.jp
Yoshiaki Wada +81-3-3277-1478
Financial Data Center, Financial Systems and Bank Examination Department

1. XBRL (eXtensible Business Reporting Language) is a data format developed to facilitate the transfer of financial data between computers. Based upon eXtensible Markup Language (XML) technology, it is specially designed for transferring financial data, and has a unique feature that allows it to handle both the data and its attributes at the same time.
2. B/S stands for balance sheet.
3. In the accompanying illustration, IP-VPN, FSIs, U/L, and D/L stand for Internet Protocol Virtual Private Network, Financial Service Institutions, Upload, and Download, respectively.

February 24, 2006
Ministry of Finance of Japan, Bank of Japan
Ministry of Finance and Economy of Korea, Bank of Korea

Signing of the second Bilateral Swap Arrangement between Japan and Korea under the Chiang Mai Initiative

1. The Bank of Japan, acting as the agent for the Minister of Finance of Japan, and the Bank of Korea (BOK), today, signed a second bilateral swap arrangement (BSA) under the Chiang Mai Initiative (CMI). The agreement will enable both countries to swap their local currencies (i.e., Korean won or Japanese yen) against US dollars. Under the agreement, Japan commits USD 10 billion while Korea commits USD 5 billion.

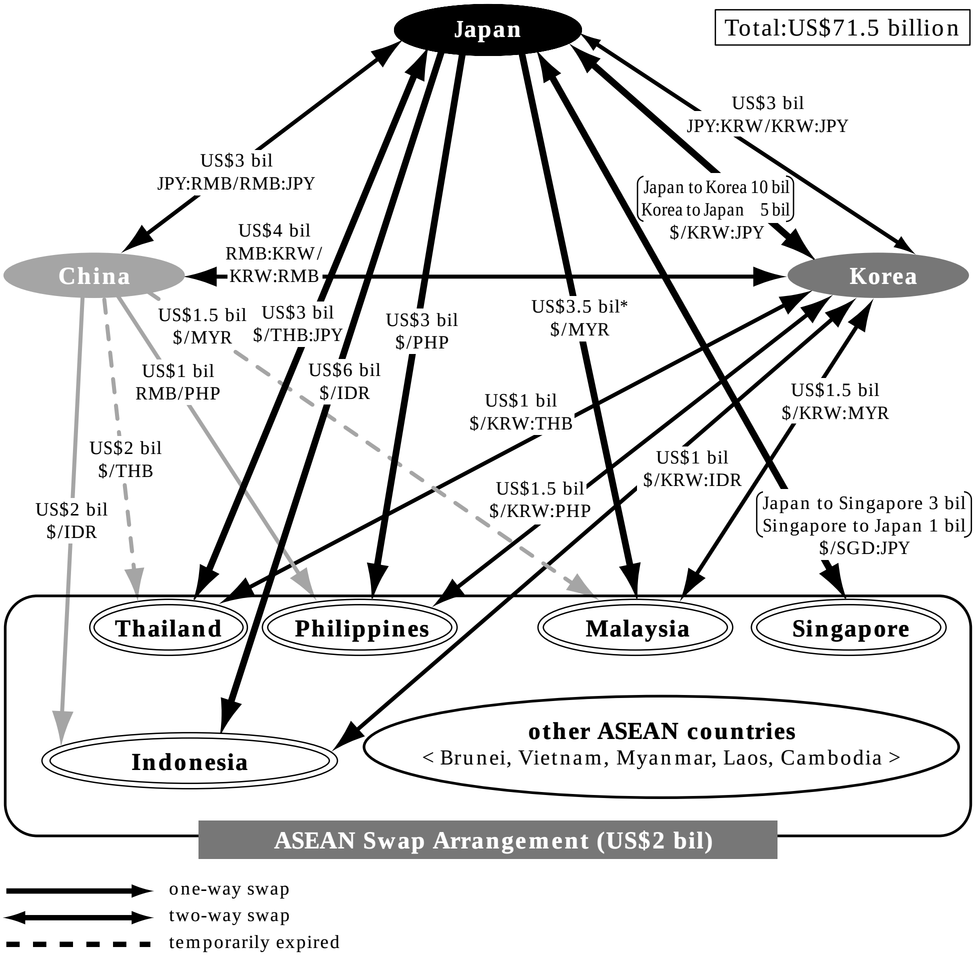
2. This second BSA features a two-way nature, in which both Japan and Korea will provide US dollars through currency swaps upon request from each other, as opposed to the first one-way BSAs, in which only Korea could draw. This is an evidence of Japan and Korea's strong commitment to the regional financial cooperation in the context of Finance Ministries' and Central Banks' endeavor of the ASEAN+3.

3. This second BSA also incorporates those measures such as an integration of ASEAN+3 economic surveillance, an increase in the size of swaps that could be withdrawn without the IMF-supported program (from 10% to 20%) along the lines with what the ASEAN+3 Finance Ministers agreed in Istanbul in May 2005. The new BSA is expected to contribute to the stability of regional financial markets in East Asia.

Note
The previous two "one-way" BSAs between Japan and Korea have been terminated.
(1) BSA under the New Miyazawa Initiative up to USD 5 billion (concluded in June 1999).
(2) BSA under the CMI up to USD 2 billion (concluded in July 2001).
See the annex figure.

Annex

The Agreement on the Swap Arrangement under the Chiang Mai Initiative (as of February 24, 2006)



*** Including New Miyazawa Initiative**

The agreement between Japan and Malaysia: US$2.5 billion under the New Miyazawa Initiative
US$1 billion under the Chiang Mai Initiative

Note: Total amount does not include New Miyazawa Initiative and ASEAN swap arrangement.

March 31, 2006
Bank of Japan

Release of the "Payment and Settlement Systems Report"[1,2]

On March 6, 2006, the Bank of Japan released the first issue of the "Payment and Settlement Systems Report."

The report (1) presents the Bank's findings following an analysis of trends in the transaction volume and value of Japan's payment and settlement systems, and provides information on the progress in reform of these systems; (2) identifies improvements that can be made to enhance the safety and efficiency of Japan's payment and settlement systems, and explains how system operators and the Bank are addressing them; and (3) introduces the Bank's work on payment and settlement systems with the aim of contributing to worldwide research on payment and settlement issues.

The report is prepared by the Payment and Settlement Systems Department.

This issue of the "Payment and Settlement Systems Report" focuses mainly on developments in 2005 and as the first issue, also explains details of settlement mechanisms and the risk management framework of Japan's payment and settlement systems. Appendices in the report provide background information on Japan's payment and settlement systems, including a chronological table of major events, a summary of internationally recognized standards, and a selected bibliography on payment and settlement systems.

1. The full text is available only in Japanese and can be accessed at the Bank's web site (http://www.boj.or.jp).
2. An outline of the paper can be found on pages 117–120 of this issue of the *Bank of Japan Quarterly Bulletin*.

March 31, 2006
Bank of Japan

Statistical Releases and Publications Scheduled for the Next Six Months from April to September 2006[1]

Notice

- The release time of "Sources of Changes in Current Account Balances at the Bank of Japan and Market Operations" (Preliminary Figures) will be changed, starting with April 2006 figures. (March 31, 2006)
- The release time of "Figures on Reserves" will be changed, starting with March 2006 figures. (March 31, 2006)

Statistics

	Release time (frequency of release)	Apr. 2006	May	June	July	Aug.	Sep.
Business Survey							
Tankan **(Short-Term Economic Survey of Enterprises in Japan)[2]**							
Summary[3] and Outline	**8:50 a.m.** (Quarterly)	(Mar. Survey) **3 (Mon.)**	—	—	(June Survey) **3 (Mon.)**	—	—
Figures by Industry and The Comprehensive Data Set	**8:50 a.m.** (Quarterly)	(Mar. Survey) **4 (Tue.)**	—	—	(June Survey) **4 (Tue.)**	—	—
Currency							
Money Stock (Preliminary Figures)	**8:50 a.m.** (Monthly)	(For Mar.) **12 (Wed.)**	(For Apr.) **11 (Thur.)**	(For May) **8 (Thur.)**	(For June) **10 (Mon.)**	(For July) **8 (Tue.)**	(For Aug.) **8 (Fri.)**
Monetary Survey[4]	**8:50 a.m.** (Monthly)	(For Feb.) **14 (Fri.)**	(For Mar.) **17 (Wed.)**	(For Apr.) **14 (Wed.)**	(For May) **14 (Fri.)**	(For June) **14 (Mon.)**	(For July) **14 (Thur.)**
Issuance of New Series Bank of Japan Notes[4]	**3:00 p.m.** (Monthly)	(For Mar.) **5 (Wed.)**	(For Apr.) **8 (Mon.)**	(For May) **5 (Mon.)**	(For June) **5 (Wed.)**	(For July) **3 (Thur.)**	(For Aug.) **5 (Tue.)**
Receipts and Payments of Banknotes and Coins[4]	**8:50 a.m.** (Annually)	—	—	—	—	—	—
Banknotes in Circulation at the End of the Year[4]	**Around 7:50 p.m.** (Annually)	—	—	—	—	—	—

	Release time (frequency of release)	Apr. 2006	May	June	July	Aug.	Sep.
Bank of Japan							
Sources of Changes in Current Account Balances at the Bank of Japan and Market Operations (Final Figures)	**1:00 p.m.** (Monthly)	(For Mar.) 3 (Mon.)	(For Apr.) 1 (Mon.)	(For May) 1 (Thur.)	(For June) 3 (Mon.)	(For July) 1 (Tue.)	(For Aug.) 1 (Fri.)
Sources of Changes in Current Account Balances at the Bank of Japan (Projections)	**8:50 a.m.** (Monthly)	(For Apr.) 4 (Tue.)	(For May) 2 (Tue.)	(For June) 2 (Fri.)	(For July) 4 (Tue.)	(For Aug.) 2 (Wed.)	(For Sep.) 4 (Mon.)
Sources of Changes in Current Account Balances at the Bank of Japan and Market Operations (Preliminary Figures)	**Around 7:30 p.m.** (Monthly)	(For Apr.) 28 (Fri.)	(For May) 31 (Wed.)	(For June) 30 (Fri.)	(For July) 31 (Mon.)	(For Aug.) 31 (Thur.)	(For Sep.) 29 (Fri.)
Sources of Changes in Current Account Balances at the Bank of Japan and Market Operations (Final Results)	**Around 10:00 a.m.** (Daily)	**Every business day**					
Sources of Changes in Current Account Balances at the Bank of Japan and Market Operations (Provisional Results)	**Around 6:00 p.m.**[5] (Daily)	**Every business day**					
Sources of Changes in Current Account Balances at the Bank of Japan and Market Operations (Projections)	**Around 6:00 p.m.**[5] (Daily)	**Every business day**					
Japanese Government Bonds Held by the Bank of Japan	**Around 5:00 p.m.** (Monthly)	(For Mar.) 4 (Tue.)	(For Apr.) 2 (Tue.)	(For May) 2 (Fri.)	(For June) 4 (Tue.)	(For July) 2 (Wed.)	(For Aug.) 4 (Mon.)
TBs and FBs Purchased by the Bank of Japan	**Around 5:00 p.m.** (Monthly)	(For Mar.) 4 (Tue.)	(For Apr.) 2 (Tue.)	(For May) 2 (Fri.)	(For June) 4 (Tue.)	(For July) 2 (Wed.)	(For Aug.) 4 (Mon.)

	Release time (frequency of release)	Apr. 2006	May	June	July	Aug.	Sep.
Collateral Accepted by the Bank of Japan	Around 5:00 p.m. (Monthly)	(For Mar.) 4 (Tue.)	(For Apr.) 2 (Tue.)	(For May) 2 (Fri.)	(For June) 4 (Tue.)	(For July) 2 (Wed.)	(For Aug.) 4 (Mon.)
Changes in the Amount Outstanding of Japanese Government Bonds Held by the Bank of Japan[4,6]	Undecided (Annually)	—	—	—	—	—	—
Figures on Reserves	Around 7:00 p.m. (Monthly)	(For Mar.) 14 (Fri.)	(For Apr.) 15 (Mon.)	(For May) 15 (Thur.)	(For June) 14 (Fri.)	(For July) 15 (Tue.)	(For Aug.) 15 (Fri.)
Results of Bid for Money Market Operations Conducted by the Bank of Japan	After the announcement of the results of auctions (Daily)	The day the money market operation is conducted					
Bank of Japan Operations in the Money Markets	Undecided (Monthly)	(For Mar.) 3 (Mon.)	(For Apr.) 1 (Mon.)	(For May) 1 (Thur.)	(For June) 3 (Mon.)	(For July) 1 (Tue.)	(For Aug.) 1 (Fri.)
Monetary Base	8:50 a.m. (Monthly)	(For Mar.) 4 (Tue.)	(For Apr.) 2 (Tue.)	(For May) 2 (Fri.)	(For June) 4 (Tue.)	(For July) 2 (Wed.)	(For Aug.) 4 (Mon.)
Monetary Base and the Bank of Japan's Transactions	8:50 a.m. (Monthly)	(For Mar.) 7 (Fri.)	(For Apr.) 10 (Wed.)	(For May) 7 (Wed.)	(For June) 7 (Fri.)	(For July) 7 (Mon.)	(For Aug.) 7 (Thur.)
Bank of Japan's Transactions with the Government	8:50 a.m. (Monthly)	(For Mar.) 7 (Fri.)	(For Apr.) 10 (Wed.)	(For May) 7 (Wed.)	(For June) 7 (Fri.)	(For July) 7 (Mon.)	(For Aug.) 7 (Thur.)
Bank of Japan Accounts	10:00 a.m. (Every ten days)	7 (Fri.) 12 (Wed.) 24 (Mon.)	2 (Tue.) 12 (Fri.) 23 (Tue.)	2 (Fri.) 13 (Tue.) 22 (Thur.)	4 (Tue.) 12 (Wed.) 24 (Mon.)	2 (Wed.) 14 (Mon.) 22 (Tue.)	4 (Mon.) 12 (Tue.) 22 (Fri.)
Principal Figures of Bank of Japan Accounts (Banknotes, Loans and Discounts, and Government Securities)[4,6]	Next business day 11:00 a.m. (Daily)	Every business day					

	Release time (frequency of release)	Apr. 2006	May	June	July	Aug.	Sep.
Deposits and Loans Market							
Average Interest Rates Posted at Financial Institutions by Type of Deposit	**8:50 a.m.** (Weekly)	5 (Wed.) 12 (Wed.) 19 (Wed.) 26 (Wed.)	8 (Mon.) 10 (Wed.) 17 (Wed.) 24 (Wed.) 31 (Wed.)	7 (Wed.) 14 (Wed.) 21 (Wed.) 28 (Wed.)	5 (Wed.) 12 (Wed.) 20 (Thur.) 26 (Wed.)	2 (Wed.) 9 (Wed.) 16 (Wed.) 23 (Wed.) 30 (Wed.)	6 (Wed.) 13 (Wed.) 21 (Thur.) 27 (Wed.)
Average Contracted Interest Rates on Loans and Discounts	**8:50 a.m.** (Monthly)	—	(For Mar.) 24 (Wed.) (For Apr.) 30 (Tue.)	(For May) 29 (Thur.)	(For June) 31 (Mon.)	(For July) 29 (Tue.)	(For Aug.) 29 (Fri.)
Principal Figures of Financial Institutions (Preliminary Figures)	**8:50 a.m.** (Monthly)	(For Mar.) 12 (Wed.)	(For Apr.) 11 (Thur.)	(For May) 8 (Thur.)	(For June) 10 (Mon.)	(For July) 8 (Tue.)	(For Aug.) 8 (Fri.)
Data on Commitment Lines Extended by Japanese Banks	**8:50 a.m.** (Monthly)	(For Mar.) 28 (Fri.)	(For Apr.) 31 (Wed.)	(For May) 30 (Fri.)	(For June) 31 (Mon.)	(For July) 31 (Thur.)	(For Aug.) 29 (Fri.)
Loans Syndicated and Loans Transferred	**8:50 a.m.** (Quarterly)	(For Jan.–Mar.) 28 (Fri.)	—	—	(For Apr.–June) 31 (Mon.)	—	—
Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks[7]	**8:50 a.m.** (Quarterly)	(Apr. Survey) 24 (Mon.)	—	—	(July Survey) Late in the month	—	—
Deposits, Vault Cash, and Loans and Discounts Outstanding of Domestically Licensed Banks by Prefecture[4]	**8:50 a.m.** (Monthly)	—	(For Mar.) 2 (Tue.)	(For Apr.) 1 (Thur.) (For May) 29 (Thur.)	(For June) 31 (Mon.)	(For July) 31 (Thur.)	(For Aug.) 29 (Fri.)
Flow of Funds Accounts							
Flow of Funds Accounts (Preliminary Figures)	**8:50 a.m.** (Quarterly)	—	—	(For 1st Quarter) 15 (Thur.)	—	—	(For 2nd Quarter) 15 (Fri.)
Flow of Funds Accounts (Revised Figures)	**8:50 a.m.** (Quarterly)	—	—	(For 4th Quarter) 15 (Thur.)	—	—	(For 1st Quarter) 15 (Fri.)

	Release time (frequency of release)	Apr. 2006	May	June	July	Aug.	Sep.
Short-Term Money Market							
Uncollateralized Overnight Call Rate (Provisional Results)	**Around 5:15 p.m.[8] (Daily)**	**Every business day**					
Uncollateralized Overnight Call Rate (Final Results)	**Next business day Around 10:00 a.m. (Daily)**	**Every business day**					
Amounts Outstanding in the Call Money Market[4]	**3:00 p.m. (Monthly)**	**(For Mar.) 7 (Fri.)**	**(For Apr.) 10 (Wed.)**	**(For May) 7 (Wed.)**	**(For June) 7 (Fri.)**	**(For July) 7 (Mon.)**	**(For Aug.) 7 (Thur.)**
Repo Rate (Indication, Aggregated)	**Around 5:30 p.m. (Daily)**	**Every business day**					
Foreign Exchange Market							
Foreign Exchange Rates	**5:00 p.m. (Monthly)**	**(For Mar.) 3 (Mon.)**	**(For Apr.) 1 (Mon.)**	**(For May) 1 (Thur.)**	**(For June) 3 (Mon.)**	**(For July) 1 (Tue.)**	**(For Aug.) 1 (Fri.)**
Clearing							
Payment and Settlement Statistics[7]	**11:00 a.m. (Monthly)**	**(For Feb.) 10 (Mon.) or 11 (Tue.)**	**(For Mar.) 11 (Thur.) or 12 (Fri.)**	**(For Apr.) 8 (Thur.) or 9 (Fri.)**	**(For May) 10 (Mon.) or 11 (Tue.)**	**(For June) 8 (Tue.) or 9 (Wed.)**	**(For July) 8 (Fri.) or 11 (Mon.)**
Figures on Settlement of Japanese Government Bonds	**4:30 p.m. (Monthly)**	**(For Mar.) 12 (Wed.)**	**(For Apr.) 15 (Mon.)**	**(For May) 12 (Mon.)**	**(For June) 12 (Wed.)**	**(For July) 10 (Thur.)**	**(For Aug.) 12 (Tue.)**
Prices							
Monthly Report on the Corporate Goods Price Index	**8:50 a.m. (Monthly)**	**(For Mar.) 13 (Thur.)**	**(For Apr.) 15 (Mon.)**	**(For May) 12 (Mon.)**	**(For June) 12 (Wed.)**	**(For July) 10 (Thur.)**	**(For Aug.) 12 (Tue.)**
Monthly Report on the Corporate Service Price Index	**8:50 a.m. (Monthly)**	**(For Mar.) 25 (Tue.)**	**(For Apr.) 26 (Fri.)**	**(For May) 26 (Mon.)**	**(For June) 26 (Wed.)**	**(For July) 24 (Thur.)**	**(For Aug.) 26 (Tue.)**
Monthly Report on the Input-Output Price Index of the Manufacturing Industry by Sector	**8:50 a.m. (Monthly)**	**(For Mar.) 17 (Mon.)**	**(For Apr.) 17 (Wed.)**	**(For May) 14 (Wed.)**	**(For June) 14 (Fri.)**	**(For July) 14 (Mon.)**	**(For Aug.) 14 (Thur.)**

	Release time (frequency of release)	Apr. 2006	May	June	July	Aug.	Sep.
Statistics Related to BIS							
Results of the Regular Derivatives Market Statistics in Japan (Yoshikuni Statistics)[7]	**8:50 a.m.** (Semiannually)	—	—	—	—	(For June) **Undecided**	—
Central Bank Survey of Foreign Exchange and Derivatives Market Activity[7]	**Undecided** (Triennially)	**The latest turnover and outstanding amount survey results for April and June 2004 were released on September 29, 2004 and December 6, 2004, respectively. The next survey is scheduled to be conducted in 2007.**					
Results of Locational International Banking Statistics and Consolidated International Banking Statistics in Japan[7]	**8:50 a.m.** (Quarterly)	—	—	(For Mar.) **Late in the month**	—	—	(For June) **Late in the month**
Balance of Payments[9]							
Balance of Payments (Preliminary Figures)	**8:50 a.m.** (Monthly)	(For Feb.) **12 (Wed.)**	(For Mar.) **15 (Mon.)**	(For Apr.) **12 (Mon.)**	(For May) **13 (Thur.)**	(For June) **10 (Thur.)**	(For July) **13 (Wed.)**
Balance of Payments (Revised Figures)	**8:50 a.m.** (Quarterly)	(For Oct.–Dec.) **12 (Wed.)**	—	—	(For Jan.–Mar.) **13 (Thur.)**	—	—
Regional Balance of Payments	**8:50 a.m.** (Quarterly)	—	(For 4Q/2005) **15 (Mon.)**	—	—	(For 1Q/2006) **10 (Thur.)**	—
Gross External Debt Position of Japan (Preliminary Estimate)	**8:50 a.m.** (Quarterly)	—	—	(For Mar.) **12 (Mon.)**	—	—	(For June) **13 (Wed.)**
Gross External Debt Position of Japan (Revised Estimate [end-Dec. figures are final figures])	**8:50 a.m.** (Quarterly)	—	—	(For Dec.) **12 (Mon.)**	—	—	(For Mar.) **13 (Wed.)**
Others							
Real Exports and Real Imports (Preliminary Figures)[4,7]	**2:00 p.m.** (Monthly)	(For Mar.) **Late in the month**	(For Apr.) **Late in the month**	(For May) **Late in the month**	(For June) **Late in the month**	(For July) **Late in the month**	(For Aug.) **Late in the month**

	Release time (frequency of release)	Apr. 2006	May	June	July	Aug.	Sep.
Business Conditions DI in the Kanto Koshinetsu Region[4,7]	**Undecided** (Quarterly)	(For Apr.) 18 (Tue.)	Data for the remaining quarters will be released on the day of the Bank's branch managers' meeting				
Business Conditions DI in the Tokai Region[4,7]	**Undecided** (Quarterly)	(For Apr.) 18 (Tue.)	Data for the remaining quarters will be released on the day of the Bank's branch managers' meeting				

Notes: *1.* The Bank aims to release statistics and statistical publications immediately on completion. However, the release may be postponed to a later date in case of system problems or any other unexpected disruption. Changes to the schedule will be announced on the Bank's web site (http://www.boj.or.jp/en/index.htm).
The schedule for releases from July to December 2006 will be available at 4:30 p.m. on June 30, 2006.
2. The questionnaires for the June survey will be mailed to respondents on May 31, 2006.
The questionnaires for the September survey will be mailed to respondents on August 30, 2006.
3. The "*TANKAN Summary (Number of employees basis)*" will be released one business day after the release of the "*TANKAN Summary*."
4. Available only in Japanese.
5. "Sources of Changes in Current Account Balances at the Bank of Japan and Market Operations (Provisional Results)" and "Sources of Changes in Current Account Balances at the Bank of Japan and Market Operations (Projections)" are released at around 7:00 p.m. on the last business day of the month.
6. Not available on the Bank's web site. For further information, please contact +81-3-3279-1111 (ext. 4641).
7. Where no release date is given, the date will be announced in "Releases Scheduled for the Next Four Weeks" as soon as it has been decided.
8. "Uncollateralized Overnight Call Rate (Provisional Results)" is released at around 6:15 p.m. on the last business day of the month.
9. Balance of payments data are compiled jointly by the Ministry of Finance and the Bank of Japan.

Publications[1]

	Release time on the Bank's web site	Apr. 2006	May	June	July	Aug.	Sep.
Financial and Economic Statistics Monthly	**8:50 a.m.[2]**	(Apr. Issue) 26 (Wed.)	(May Issue) 29 (Mon.)	(June Issue) 26 (Mon.)	(July Issue) 27 (Thur.)	(Aug. Issue) 24 (Thur.)	(Sep. Issue) 27 (Wed.)
Bank of Japan Statistics	**8:50 a.m.**	—	(Spring Issue) 16 (Tue.)	—	—	(Summer Issue) 11 (Fri.)	—
Price Indexes Monthly	**8:50 a.m.**	(For Feb.) 4 (Tue.)	(For Mar.) 8 (Mon.)	(For Apr.) 5 (Mon.)	(For May) 4 (Tue.)	(For June) 3 (Thur.)	(For July) 1 (Fri.)
***TANKAN*: The Comprehensive Data Set[3]**	**Around 8:50 a.m.**	(Mar. Survey) 10 (Mon.)	—	—	(June Survey) Undecided	—	—

Notes: *1.* "Balance of Payments Monthly" is released early in the month after that in which preliminary balance of payments data are released.
2. The PDF format typically will be available every business day on the Bank's web site.
3. The MS-Excel format will be available on the Bank's web site one business day after the release of the "*TANKAN Summary*" and "*TANKAN Outline.*"

Information about the Bank's Web Site

- The Bank of Japan Web Site
- The Bank of Japan E-Mail Service
- Speeches and Research Papers

The Bank of Japan Web Site

With the aim of further enhancing web site usability, the Bank of Japan has renewed its web site since March 20, 2006. The following are the main features of the new web site. The URL remains the same (http://www.boj.or.jp/en/index/htm).

1. New Content Structure

The new site provides the following basic ways to access the information you need.

This provides basic information about the Bank of Japan, including *Functions and Operations of the Bank of Japan* and the Bank of Japan Law.

"Outline of the Bank" gives the information such as the Bank's objectives, capital, and history.

"Organization" gives the information such as the organization chart of the Bank, the list of the members of the Policy Board, and the addresses and phone numbers of the overseas representative offices.

"PR Services" gives the information on the Bank's public relations activities, the lists of the Bank's releases of statistics and other materials and publications, and the guide for subscription.

This gives users a hint as to where various statistics and data are located and how to make the best use of them. Users can directly access major statistics from this menu.

Information is sorted by basic categories of policy and operations conducted by the Bank.

Information is sorted by document type, such as "Speeches and Statements," "Research Papers," and "Statistics."

This gives the full text (PDF file) of each issue of the *Annual Review*, beginning with the fiscal 1995 issue.

This gives the list of articles and speeches published in the *Bank of Japan Quarterly Bulletin* since the February 1993 issue. The full text (PDF file) of the *Bank of Japan Quarterly Bulletin* is available, beginning with the February 2006 issue.

2. Comparison of the Previous and New Web Sites

Previous web site		New web site
Monetary Policy		• **Policy and Operations** → Monetary Policy
Financial & Payment System		• **Policy and Operations** → Financial System Stability • **Policy and Operations** → Payment, Settlement, Market Infrastructure
About the Bank		
	Overview of the Bank	• **About the Bank** → Outline of the Bank of Japan
	Law and organization	• **Index by Document Type** → Law and Rules • **About the Bank** → Organization
	Activities	• **About the Bank** → Activities
	Financial statements	• **About the Bank** → The Bank's Accounts
	Annual Review	The left banner on the home page
	Business continuity planning	• **Policy and Operations** → Business Continuity Planning
	Swap arrangement with other central banks	• **Policy and Operations** → International Finance → Cooperation with Other Central Banks
	A map of how to get to the Head Office	• **About the Bank** → Organization → Guide Map to the Bank of Japan Tokyo Head Office
Speeches		• **Index by Document Type** → Speeches and Statements (sorted by year and date of release) • **Policy and Operations** → Communications → Speeches (sorted by speaker)
Research Papers		• **Index by Document Type** → Research Papers (sorted by year and date of release) • **Policy and Operations** → Statistics, Research and Studies → Research Papers (sorted by theme)
Release Schedule		• **Index by Document Type** → Release Schedule

The Bank of Japan E-Mail Service

We have an e-mail service to notify you when new information is uploaded on the Bank of Japan's web site. If you wish to receive this service, please register your e-mail address at the English version of the Bank's web site (http://www.boj.or.jp/en/index.htm).

Speeches and Research Papers

Speeches and research papers released on the Bank's web site between February and April 2006 are listed below. To reach the documents through the Internet, access the Bank's web site (http://www.boj.or.jp/en/index.htm).

■ Speeches/Summaries of Speeches by Bank Executives

Title	Speaker	Venue	Date of speech	Date of release
The Asian Economy and Central Bank Cooperation	Eiji Hirano, (Assistant Governor)	Harvard Asia Business Conference 2006 (Boston)	February 11, 2006	February 13, 2006
New Framework for the Conduct of Monetary Policy: Toward Achieving Sustainable Economic Growth with Price Stability[1]	Toshihiko Fukui (Governor)	Japan Chamber of Commerce and Industry (Tokyo)	March 16, 2006	March 16, 2006
Statement before the House of Councillors[1]	Toshihiko Fukui (Governor)	Committee on Financial Affairs (Tokyo)	February 21, 2006	March 28, 2006
Statement before the House of Representatives[1]	Toshihiko Fukui (Governor)	Committee on Financial Affairs (Tokyo)	March 10, 2006	April 7, 2006
Recent Financial and Economic Developments and Monetary Policy	Atsushi Mizuno (Member of the Policy Board)	Meeting with Business Leaders (Shiga)	March 13, 2006	April 12, 2006
Speech in Toyama	Shin Nakahara (Member of the Policy Board)	Meeting with Business Leaders (Toyama)	March 23, 2006	April 19, 2006

■ Bank of Japan Research Papers/Working Paper Series[2]

Title	Author(s)	Category	Date of release
Nonlinear Income Variance Profile and Consumption Inequality over the Life Cycle	Naohito Abe and Tomoaki Yamada	Working Paper Series	February 7, 2006
Results of the 24th Opinion Survey on the General Public's Mindset and Behavior	Public Relations Department	Research Papers	February 15, 2006
Determinacy and Expectational Stability of Equilibrium in a Monetary Sticky-Price Model with Taylor Rule	Takushi Kurozumi	Working Paper Series	February 17, 2006
U.S. R&D and Japanese Medium Term Cycles	R. Anton Braun, Toshihiro Okada, and Nao Sudou	Working Paper Series	March 20, 2006
Default Intensity and Expected Recovery of Japanese Banks and "Government": New Evidence from the CDS Market	Yoichi Ueno and Naohiko Baba	Working Paper Series	March 24, 2006

Notes: 1. Published in the *Bank of Japan Quarterly Bulletin*.
2. The Bank introduced the series to invite comments on working papers written by the Bank's staff and outside researchers.

Title	Author(s)	Category	Date of release
■ Bank of Japan Research Papers/Working Paper Series[1] (continued)			
Survival Analysis of Hedge Funds	Naohiko Baba and Hiromichi Goko	Working Paper Series	March 24, 2006
Improvement of Statistics on International Workers' Remittances—International Discussions and Present Situation in Japan	Hidenori Satake and Michelle Hassine	Working Paper Series	March 31, 2006
Estimating Continuous Time Transition Matrices from Discretely Observed Data	Yasunari Inamura	Working Paper Series	April 20, 2006

Note: *1*. The Bank introduced the series to invite comments on working papers written by the Bank's staff and outside researchers.