

Monetary Policy

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I. SUMMARY

The Bank of Japan decides and implements monetary policy.

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

The Law stipulates that monetary policy shall be decided by the Policy Board at Monetary Policy Meetings (MPMs).

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

The Bank held 15 MPMs in fiscal 2005. (For the guidelines for money market operations decided at these MPMs, see Table 1.)

II. ECONOMIC AND FINANCIAL DEVELOPMENTS IN FISCAL 2005

In fiscal 2005, Japan's economy continued to recover. The growth of the economy slowed temporarily up until the summer, but thereafter it emerged from this pause.

The momentum of growth in exports, particularly to China, remained weak up until the first half of fiscal 2005, but continued to increase thereafter against the background of the expansion of overseas economies. Business fixed investment continued to increase against the background of high corporate profits. Meanwhile, public investment was basically on a downtrend.

Looking at the employment and income situation, household income rose moderately, as employment and wages improved reflecting more favorable supply and demand conditions in the labor market. In this situation, private consumption continued to be steady. Housing investment showed some strength in the second half of fiscal 2005.

Production followed an increasing trend against the background of the continuing increases in domestic and external demand.

As for prices, domestic corporate goods prices continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen in the second half of 2005. The year-on-year change in consumer prices (excluding fresh food) remained slightly below zero percent in the first half of fiscal 2005, but turned positive from November onward, as supply-demand conditions continued improving gradually and the effects of the reduction in electricity and telephone charges in the second half of fiscal 2004 dissipated.

The Policy Board members' assessment of the economic and financial situation is expressed in "The Bank's View" in the *Monthly Report of Recent Economic and Financial Developments*. (For a list of the opening

sentences of “The Bank’s View” in fiscal 2005, see Table 2.)¹

The Bank also released its assessments of economic activity and prices and provided Policy Board members’ forecasts of economic growth and inflation as reference figures in the issues of the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) published on April 28 and October 31, 2005, after determining their contents at the respective MPMs. From fiscal 2005, the Bank decided to extend the projection period in the April

Outlook Report by one year and to provide an outlook for the current and following fiscal years.

Furthermore, the Bank made interim assessments of the outlook laid out in these two publications at separate MPMs on July 12 and 13, 2005, and also on January 19 and 20, 2006. These interim assessments were published in “The Bank’s View” in the *Monthly Report of Recent Economic and Financial Developments*. The text of these publications is available on the Bank’s web site.

III. MONETARY POLICY IN FISCAL 2005

A. Overview

At the MPMs held from April 5 and 6, 2005 to February 8 and 9, 2006, the Bank decided to maintain its guideline for money market operations. Under the quantitative easing policy framework, in which the operating target for money market operations was the outstanding balance of current accounts held at the Bank, it conducted money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen based on a clear commitment to maintain the quantitative easing policy until the year-on-year rate of change in the consumer price index (CPI; excluding fresh food, on a nationwide basis) registered zero percent or higher on a sustainable basis. At the MPM on May 19 and 20, 2005, the Bank decided to amend the proviso in the guideline for money market operations, stating that when it was judged that

liquidity demand was exceptionally weak considering such factors as responses of financial institutions to the Bank’s funds-supplying operations, there might be cases where the balance of current accounts temporarily fell short of the target. The decision was made given the frequent occurrence of undersubscription in the Bank’s funds-supplying operations, i.e., financial institutions’ bids falling short of the Bank’s offers, with market participants feeling more strongly that there was excess liquidity against the background of the stabilization of the financial system.

At the MPM on March 8 and 9, 2006, the Bank examined economic activity and prices and made the following assessment. First, Japan’s economy continued to recover steadily with domestic and external demand and also the corporate and household sectors well in balance, and was likely to experience a sustained recovery.

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

And second, in this situation, the year-on-year change in the CPI had turned positive and was expected to remain positive. The Bank, therefore, judged that the conditions laid out in the commitment regarding the termination of the quantitative easing policy had been fulfilled. As a result, 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 following guideline for money market operations for the intermeeting period: The Bank of Japan would encourage the uncollateralized overnight call rate to remain at effectively zero percent. The decision was announced in the public statement, released on March 9, 2006, which follows.

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.

B. Introduction of a New Framework for the Conduct of Monetary Policy

At the MPM held on March 8 and 9, 2006, the Bank decided to introduce a new framework for the conduct of monetary policy as well as to review its thinking on price stability, from the viewpoint of ensuring the

transparency of the conduct of monetary policy in terminating the quantitative easing policy and changing the operating target of money market operations to the uncollateralized overnight call rate. The decision was announced in the public statement which follows.

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.

IV. REVISIONS OF MONETARY POLICY TOOLS

In fiscal 2005, the Bank decided on the following measures related to its monetary policy tools, with a view to improving the procedures for carrying out money market operations.

A. Relaxation of the Eligibility Criteria for Counterparties in the Bank's Money Market Operations

At the MPM on May 19 and 20, 2005, the Bank decided to take necessary measures to accept, as eligible counterparties in the Bank's operations, financial institutions that entrusted other financial institutions with settlement of Japanese government securities (JGSs) and funds accompanying money market operations conducted by the Bank such as purchase/sale of JGSs with repurchase agreements. The decision was made given the moves among financial institutions to entrust settlement of JGSs and funds accompanying JGS transactions to other financial institutions, and among other financial institutions to take on such settlement.

B. Revision of Conditions for Including in the Range of Eligible Collateral Bonds Whose Principal Balance May Decrease Due to Prepayments before the Final Maturity Date

With regard to "bonds whose principal balance may decrease due to prepayments before the final maturity date," such as pass-through bonds, the Bank decided at the MPM on June 14 and 15, 2005, to amend its Guidelines on Eligible Collateral (established on

October 13, 2000), by revising the method for calculating collateral prices so as to include in the range of eligible collateral those issued more than five years ago, the amount outstanding of which was expected to increase.

C. Amendment to the Margin Tables for Eligible Collateral and Examination of Possible Revisions to the Bill Purchasing Scheme

At the MPM on September 7 and 8, 2005, the Bank decided to revise the margin tables for eligible collateral and to look into revising the bill purchasing scheme. The decision was made to maintain the soundness of the Bank's assets, contribute to market participants' efficient use of collateral, and facilitate efficient money market operations, taking into account recent developments in financial markets such as the volatility of market interest rates and changes in transaction procedures.

The Bank decided to revise the margin tables for eligible collateral, given that considerable time had passed since the Bank originally established them in 2000, taking into account subsequent developments in financial markets such as the volatility of market interest rates. The Bank will, as a rule, examine annually whether there is a need for further revision.

The Bank decided to publish the provisional findings of its examination of possible revisions to the bill purchasing scheme in order to make transactions related to bill purchasing operations, which were the Bank's main measures to provide funds at the time, paperless. The decision was made taking into account requests from

counterparties in the Bank's money market operations given the progress in paperless transactions in financial markets. The Bank announced a plan to introduce the new procedures in or after the middle of 2006, after the necessary preparations have been made.²

D. The Expiry of Temporary Measures, Including Purchases of Asset-Backed Securities

At the MPM on December 15 and 16, 2005, the Bank decided to announce, for immediate release, that the following temporary measures would be allowed to expire, as scheduled, at the end of March 2006: those relating to the purchases of asset-backed securities (ABSs) based on the Principal Terms and Conditions for

the Outright Purchases of Asset-Backed Securities and on the procedure for selection of eligible counterparties to outright purchases of ABSs (both established on June 25, 2003); and those relating to the relaxing of eligibility standards for accepting asset-backed CP in its market operations based on the Temporary Rules of Eligibility Standards for Asset-Backed Commercial Paper and Dematerialized Asset-Backed Commercial Paper (established on December 17, 2002). The decision was made so as to ensure that these measures could be terminated smoothly, with the Bank also deciding to adopt a necessary transitional measure.

The above measures expired at the end of March 2006. The total value of ABSs purchased outright by the Bank since July 2003 amounted to 3,288.8 billion yen.

2. At the MPM on April 10 and 11, 2006, the Bank decided to establish Principal Terms and Conditions for Funds-Supplying Operations against Pooled Collateral. Subsequently, the Bank introduced the new procedures on June 26, 2006.

Table 1

Guidelines for Money Market Operations Decided by the Policy Board at Monetary Policy Meetings in Fiscal 2005

Date		Guideline	Votes
2005	Apr. 6	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.	Majority vote (one vote against)
	Apr. 28	As above	Majority vote (two votes against)
	May 20	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.	As above
	June 15	As above	As above
	July 13	As above	As above
	July 27	As above	As above
	Aug. 9	As above	As above
	Sep. 8	As above	As above
	Oct. 12	As above	As above
	Oct. 31	As above	As above
	Nov. 18	As above	As above
	Dec. 16	As above	As above
2006	Jan. 20	As above	As above
	Feb. 9	As above	As above
	Mar. 9	The Bank of Japan will encourage the uncollateralized overnight call rate to remain at effectively zero percent.	Majority vote (one vote against)

Table 2

Opening Sentences of "The Bank's View" in Fiscal 2005

Date		Opening sentence
2005	Apr.	Japan's economy continues a recovery trend, albeit with adjustments in IT-related sectors.
	May	As above
	June	As above
	July	Japan's economy continues to recover, albeit with adjustments in IT-related sectors.
	Aug.	Japan's economy continues to recover, with the progress of adjustments in IT-related sectors.
	Sep.	Japan's economy continues to recover.
	Oct.	As above
	Nov.	As above
	Dec.	As above
2006	Jan.	Japan's economy continues to recover steadily.
	Feb.	As above
	Mar.	As above