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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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Summary of the *Semiannual Report on Currency and Monetary Control* for the Second Half of Fiscal 2005

Economic Developments[1]

1. Japan's economy continued to recover steadily in the second half of fiscal 2005 (October 2005–March 2006).

   Exports continued to increase against the background of the expansion of overseas economies, and the uptrend in industrial production became evident. Business fixed investment continued to increase against the background of high corporate profits. Household income continued rising moderately, reflecting improvements in employment and wages. Under these circumstances, private consumption was more solid. Housing investment showed some strength. Meanwhile, public investment was on a downtrend.

2. The year-on-year rate of increase in domestic corporate goods prices rose gradually, reflecting the rise in commodity prices at home and abroad and the improvement in supply and demand conditions. The year-on-year rate of change in the consumer price index (CPI; excluding fresh food) became positive in November 2005 and remained positive thereafter.

Financial Developments

3. In the money market, the uncollateralized overnight call rate was at around zero percent generally throughout the second half of fiscal 2005. Interest rates on term instruments were stable at low levels until early February 2006, but rose somewhat thereafter, factoring in a possible termination of the quantitative easing policy.

   Long-term interest rates rose, albeit with some fluctuations, reflecting a further improvement in business sentiment, rises in long-term interest rates overseas, for example in the United States, and emergence of various views regarding the future conduct of monetary policy. They were at the 1.75–1.80 percent level at the end of fiscal 2005.

   The Nikkei 225 Stock Average rose substantially from the beginning of the second half of fiscal 2005 until mid-January 2006, reflecting stronger-than-expected Japanese economic indicators and announcements of business performance by Japanese firms. Although it declined in mid-January, it continued to be on a rising trend on the whole, and passed the 17,000 yen level at the end of fiscal 2005.

   The yen was on a depreciating trend against the U.S. dollar from the beginning of the second half of fiscal 2005 partly against the background of prospects of a wider interest rate differential between Japan and the United States, declining to the 121–122 yen level through early December 2005. Thereafter it generally moved in the 114–119 yen range in a situation where there were various speculations regarding the future conduct of monetary policy in Japan and the United States.

4. The year-on-year rate of increase in the amount outstanding of lending by private banks (after adjustment for special items) continued to accelerate, and the amount outstanding of CP and corporate bonds issued was above the previous year's level. The lending attitude of private banks became more accommodative. The decline in credit demand in the private sector was coming to a halt because business outlays such as business fixed investment continued to increase in a situation where the economy continued to recover steadily.

5. The year-on-year rate of change in the monetary base (currency in circulation plus current accounts at the Bank) had been positive at the 1.0–3.0 percent level until February 2006, albeit with some fluctuations, but turned negative in March. The ratio of the monetary base to nominal GDP remained at an extremely high level.

   The year-on-year growth rate of the money stock (M_2+CDs) moved approximately in the range of 1.5 percent to 2.0 percent.

Monetary Policy Meetings (MPMs)

6. Seven MPMs were held in the second half of fiscal 2005.

   In the second half of fiscal 2005, members of the Policy Board revised their assessment from "Japan's economy continues to recover" to "Japan's economy continues to recover steadily" in January 2006, mainly because it became clearer that a virtuous cycle of production, income, and expenditure was operating.

   Members maintained the same assessment at all MPMs during the second half of fiscal 2005 that domestic corporate goods prices had continued to increase, mainly reflecting the rise in crude oil prices, and were expected to continue increasing. They confirmed at the MPMs in January and

1. The semiannual report, which included this summary, was submitted to the Diet in June 2006.

February that the year-on-year rate of change in the CPI (excluding fresh food) had been slightly positive. At the MPM in March, they confirmed that the year-on-year rate of change in the CPI had recorded a larger increase, and projected that it would follow a positive trend, albeit with some fluctuations.

7. With regard to the conduct of monetary policy, given the above economic and financial developments, members decided to maintain the guideline for money market operations aiming at an outstanding balance of current accounts at the Bank of around 30 to 35 trillion yen at MPMs during October 2005–February 2006, based on the commitment that 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.

At the MPM in March, members judged that, based on the above analysis of economic activity and prices, the condition laid out in the commitment was fulfilled. They decided to change the operating target of money market operations from the outstanding balance of current accounts to the uncollateralized overnight call rate, and to set the guideline for money market operations as follows: "The Bank of Japan will encourage the uncollateralized overnight call rate to remain at effectively zero percent." In addition, they decided to introduce a new framework for the conduct of monetary policy, as well as to review the Bank's thinking on price stability.

The Bank's Balance Sheet

8. As of the end of March 2006, the Bank's balance sheet had decreased by 3.8 percent from the previous year to 144.9 trillion yen.

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 June 16, 2006

INTRODUCTION

The Bank of Japan submitted its *Semiannual Report on Currency and Monetary Control* for the second half of fiscal 2005 to the Diet on June 9, 2006. 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

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. This strong corporate performance is benefiting the household sector. The number of employees has been increasing steadily in a situation where firms were more aware of the shortage of labor, and wages have also been rising gradually as a trend. As a result, household income has continued rising moderately. With this steady improvement in the employment and income situation, private consumption has been on an increasing trend.

Looking forward, exports are expected to continue rising against the background of further 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. Japan's economy is likely to experience a sustained period of expansion, with domestic and external demand and also the corporate and household sectors well in balance in an environment in which a virtuous cycle of production, income, and expenditure will operate.

There are various risks concerning future developments in Japan's economy. For example, prices of international commodities such as crude oil have remained at high levels. In this situation, whether the world economy, especially the U.S. economy, can maintain sustainable growth while containing inflationary risks warrants attention.

On the price front, domestic corporate goods prices have continued to increase, mainly reflecting the rise in international commodity prices, and are expected to keep increasing for the time being. The year-on-year rate of change in the consumer price index (CPI; excluding fresh food, on a nationwide basis) turned slightly positive in November 2005 and has been posting relatively clear increases since January 2006. The conditions of persistent excess supply have been dispersed, and the output gap currently seems to be close to zero. The year-on-year rate of change in the CPI is projected to continue to follow a positive trend, as the output gap is likely to gradually become positive.

As for the financial environment, the environment for corporate finance continues to be accommodative. The rate of increase in the amount outstanding of lending by private banks is accelerating in a situation where private banks have been maintaining a proactive lending posture and the decline in credit demand in the private sector has come to a halt. In the corporate bond and CP markets, the issuing environment continues to be favorable.

Large fluctuations have recently been observed globally in financial markets. The Bank will closely monitor developments in financial markets and their effects on economic activity.

II. Conduct of Monetary Policy

As I explained in my statement to this Committee in March 2006 concerning the Bank's previous *Semiannual Report on Currency and Monetary Control*, the Bank terminated the quantitative easing policy and shifted the operating target of money market operations from the outstanding balance of current accounts at the Bank to the uncollateralized overnight call rate at the Monetary Policy Meeting (MPM) held on March 8 and 9, 2006. Since then the Bank has been maintaining the guideline for money market operations that the Bank will encourage the uncollateralized overnight call rate to remain at effectively zero percent, and at the MPM held on June 14 and 15, decided to maintain this guideline.

The Bank has been reducing the outstanding balance of current accounts based on the guideline, paying due attention to the stability of the money market. Through this process, the uncollateralized overnight call rate has been stable at around zero percent, despite small temporary increases. In the call market, the volume of transactions has been gradually increasing.

The Bank has explained its basic thinking regarding the future conduct of monetary policy together with the projection for economic activity and prices in the *Outlook for Economic Activity and Prices* published at the end of April 2006 as follows. As long as Japan's economy experiences a sustained period of expansion, with domestic and external demand and also the corporate and household sectors well in balance, it seems probable that the accommodative financial conditions ensuing from very low interest rates will be maintained for some time following a period in which the uncollateralized overnight call rate is at effectively zero percent. Through and beyond this stage, the Bank will adjust the level of interest rates gradually in the light of developments in economic activity and prices. The timing of a policy change and the level of interest rates will depend on developments in economic activity and prices from this time on, and there is no predetermined view regarding the future path of monetary policy at this point.

The Bank is determined to conduct monetary policy appropriately in the light of developments in economic activity and prices, and contribute to sustainable economic growth with price stability.

The Outlook for Japan's Economy and the Conduct of Monetary Policy

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

INTRODUCTION[1]

Japan's economy has been recovering for more than four years since the trough in January 2002. The Bank of Japan projected in its *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) released on April 28, 2006 that from fiscal 2006 through fiscal 2007 the economy was likely to experience a sustained period of expansion, with domestic and external demand and also the corporate and household sectors well in balance.

Today, I will focus on the Bank's view concerning future developments in economic activity and prices given the projection in the Outlook Report, and I will explain its future monetary policy conduct.

Developments in the World Economy

I will first touch on developments in the world economy, which underlie developments in Japan's economy. The world economy has been expanding steadily since 2003, recording a growth rate of around 5 percent in 2005, and is projected to maintain high growth into the future. At the G-7 meeting held in Washington, D.C., in April 2006, finance ministers and central bank governors agreed that the outlook for the world economy remained favorable, although risks remained from factors such as oil market developments and global imbalances. They also agreed that inflation remained contained despite high oil prices and that global trade growth was buoyant.

Economic developments among Japan's main trading partners indicate that the U.S. economy continues to expand steadily, at a pace around its potential growth rate, led mainly by business fixed investment and household spending, although there are signs of a slowdown in some parts of the economy, specifically in the housing market. The Chinese economy continues to expand strongly as a whole despite some imbalance in the pace of growth between industries and regions. The NIEs and ASEAN economies continue to expand at a moderate pace on the whole, although the negative effects of high energy prices can be seen in some areas of economic activity.

Current Situation and Outlook for Japan's Economy

Turning to Japan, the economy continues to recover steadily. One of the characteristics of the current economic situation is that domestic and external demand and also the corporate and household sectors are well in balance. Exports continue to increase against the backdrop of global economic expansion and trade expansion resulting from further progress in international division of the production process. As for domestic private demand, corporate performance continues to be strong. The Bank's *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicates that corporate profits increased for the fourth consecutive fiscal year, and firms expect their sales and profits to rise in fiscal 2006. Business fixed investment plans for fiscal 2006 are relatively strong. As for the household sector, the employment and wage situation has been improving and private consumption has been on an increasing trend. Japan's economy is likely to continue to show balanced growth.

Another characteristic is that the sustained economic recovery has resulted in a higher level of utilization of resources such as capital and labor. The current recovery has already lasted for over four years, and if it continues much longer, in October 2006 it will equal the *Izanagi* boom (1965–70), which is the longest postwar economic expansion to date. As a result of the sustained recovery, according to the *Tankan*, for the first time in more than a decade firms are no longer perceiving excess capacity but have started to feel more strongly that their labor holdings are insufficient. The ratio of job offers to applicants, below 1.00 from 1992 until recently, has now exceeded 1.00 since the end of 2005. Furthermore, the conditions of persistent oversupply have been dispersed and the output gap, the difference between actual and potential output, which had long been negative, seems now to have closed. This indicates that demand and supply capacity in the economy are well balanced.

Given these characteristics of the current economic situation, the following are considered to be the three core elements of the most likely projection for economic activity and prices two years into the future.

1. This article is excerpted and translated from a speech given by Toshihiko Fukui, Governor of the Bank of Japan, to the Naigai Josei Chousa Kai (Research Institute of Japan) in Tokyo on May 15, 2006.

The first element is that the household sector is expected to be the main driving force behind firm domestic private demand.

Strong corporate performance has been benefiting the household sector, and this positive influence is likely to become more evident from now on. Employment and wages have been improving against the background of favorable corporate profits and rises in labor shortages. The number of part-time employees and bonus payments are rising, and the number of full-time employees and regular payments are also on an uptrend. These developments suggest that households can expect the increase in their income to be more permanent, and this has contributed to the improvement in consumer sentiment. Households' average propensity to consume is likely to remain at its current elevated level, and private consumption is expected to follow an increasing trend. Housing investment is likely to continue to trend moderately upward, supported by the improvement in household income and the view that interest rates will only rise from current levels, as land prices are starting to rise particularly in major metropolitan areas. Increases in household spending will feed back to the corporate sector via increases in sales and profits, and thus, a virtuous circle between the household and corporate sectors is likely to keep operating.

The second element is that there is likely to be a cyclical slowdown in the economic growth rate as the recovery has already lasted for over four years and is likely to mature.

Given the high level of corporate profits and the expansion in domestic and external demand, the momentum driving increases in business fixed investment is likely to be maintained. However, considering that there is a stable relationship in the long term between the capital stock and aggregate demand, the pace of increase in business fixed investment will probably slow eventually. Business fixed investment has steadily increased for the third consecutive year since fiscal 2003, and this has resulted in high growth in the capital stock relative to the projected increase in aggregate demand. Therefore, unless firms can make stronger forecasts for the economic growth rate and the rate of return on investment, it is becoming unlikely that they will keep up the current pace of increase in business fixed investment. In this situation, the growth rate of Japan's economy is likely to slow toward the potential growth rate, which the Bank estimates to be in the 1.5–2 percent range. The forecast is around 2.5 percent for fiscal 2006 and around 2 percent for fiscal 2007.

The third element is that, as the economic recovery matures, a slowdown in the growth in productivity and upward pressure on wages are expected to exert upward pressure on prices.

At an early stage of economic recovery, firms usually retain surplus labor and capacity and are therefore able to increase productivity by raising their rate of resource utilization. With the maturing of the economic recovery, however, firms have less scope to increase productivity in this way. As I have already explained, the output gap has closed, and as the economy is likely to continue expanding at a pace above its potential through fiscal 2007, the output gap is likely to become positive and then to widen moderately.

Moreover, in a situation of improving labor market conditions and with labor shortages being observed in a relatively wide range of industries, wages are likely to continue rising moderately. The rise in wages and the slowdown in the growth in productivity will together put upward pressure on unit labor costs (labor costs per unit of output). Through fiscal 2007, unit labor costs are likely to show smaller declines, and to start increasing slightly at some point.

One of the factors holding back upward pressures on prices during the economic recovery phase has been declining unit labor costs. As the effect of this factor diminishes, prices will be more inclined to rise than before. As for the year-on-year rate of change in the consumer price index (CPI; excluding fresh food), which has been positive since November 2005, we estimate that this will gradually rise to around the middle of the range between zero and 1 percent in fiscal 2006 and to slightly below 1 percent in fiscal 2007.

Upside and Downside Risks to the Outlook for Economic Activity

In the above sections, I have outlined the core elements of the most likely projection for economic activity and prices. However, the economy constantly faces various risks and it should be noted that, should particular risks materialize, economic activity and prices may deviate from this projection.

As downside risks to the outlook for economic activity, the April 2006 Outlook Report raises the following factors: slowdown in the growth of the world economy; and inventory adjustments, for example, in IT-related sectors. As for the first risk factor, developments in crude oil prices, which have been rising, and their impact on the world economy warrant attention. In relation to this, there is also a risk of a change in the situation where stable financial conditions are durable and inflationary pressures generally subdued which has been supporting the ongoing global economic expansion. With regard to the second factor, it should be borne in mind that inventory adjustments may be triggered as the economic recovery matures. Even if inventory adjustment occurs, it is unlikely that inventory adjustment carried out in some industries would seriously affect overall economic activity, since Japanese firms as a whole have completed adjustments in various excesses and their profitability has been recovering.

As an upside risk to the outlook for economic activity, there is a possibility of further acceleration of business fixed investment. If firms accelerate investment, there may be a positive impact on overall growth. On the other hand, such acceleration may lead to an excessive build-up of the capital stock relative to the level of expected growth in demand, which may precipitate an economic slowdown via adjustments. Given that the output gap has already closed, if economic activity accelerates further and as a result the positive output gap widens rapidly, this will increase the risk of a subsequent compensatory correction. However, large economic swings can be avoided, thereby realizing sustainable economic expansion, if firms' investment stance does not become too aggressive.

On this point, firms so far continue to increase business fixed investment based on favorable projections for sales and profits. However, overall, the value of fixed investment is being kept within the amount of firms' cash flow, and this suggests that they remain relatively cautious about accelerating fixed investment. The outlook for economic activity described earlier assumes that firms will maintain this cautious stance regarding investment.

However, the current conditions point to further acceleration in investment by firms. Looking at corporate finances, firms' risk-taking capacity has increased as a result of the reduction of their debt excesses and the strengthening of their capital bases. Levels of return on assets are comparable to those recorded during the bubble era of the late 1980s. Since interest rates are extremely low, this favorable financial environment is likely to stimulate firms' investment. A turnaround in land prices in major metropolitan areas and a rise in stock prices may also accelerate firms' investment partly through increases in household spending boosted by the wealth effect.

If firms were to further accelerate investment in this situation, overall economic growth would increase for a while, although this would generate the risk of a subsequent correction.

Upside and Downside Risks to the Outlook for Prices

The following are considered to be key upside and downside risks to the outlook for prices: the path of international commodity prices including crude oil prices; and the degree of sensitivity of the rate of increase in the CPI to economic developments, that is, changes in the output gap.

The April outlook does not assume that the rate of increase in the CPI will accelerate noticeably even when the output gap becomes positive, i.e., actual output exceeds potential output. This takes account of the weaker sensitivity of the rate of increase in the CPI to changes in the output gap, which is a tendency that has been observed in recent years not only in Japan but also worldwide. This is because prices of goods and services as well as wages have been under downward pressure due to industrialization of emerging economies as well as to firms in industrial countries shifting production facilities to overseas locations. Upward pressure on overall prices seems to have been restrained by increased productivity and intense competition both as a result of deregulation and advances in information and telecommunication technology. Additionally, in Japan unit labor costs have been able to fall considerably due to the relatively low rate of resource utilization. However, unit labor costs are expected to start increasing. Furthermore, as the output gap becomes positive, the sensitivity of prices to changes in economic activity may increase at some point, reflecting changes in firms' price-setting stance and higher inflationary expectations among the public, and thus prices may increase faster than anticipated.

The Impact of an Increase in the Potential Growth Rate

I have thus far outlined the Bank's outlook for economic activity and prices for the next two years.

I will next explain in more detail a point touched on in the projection described earlier, namely, the impact of the change in the potential growth rate on the Bank's conduct of monetary policy.

The potential growth rate seems to have been increasing recently, as a result of firms' efforts in reducing excesses in production capacity and employment and their reallocation of capital and labor to areas likely to generate higher profitability and growth in demand. The Bank estimates that the potential growth rate has recovered to the 1.5–2 percent range recently, from its previous estimate of approximately 1 percent.

When considering the impact of a rise in the potential growth rate on the conduct of monetary policy, the important point is to assess how such a rise affects aggregate supply and demand and hence prices. On the supply side, an increase in the potential growth rate gives rise to downward pressure on prices. More concretely, a rise in the potential growth rate acts to increase the supply capacity of the economy and thus exerts downward pressure on prices. Furthermore, since a rise in the potential growth rate tends to be accompanied by an increase in productivity, downward pressure may also be exerted on prices by the decrease in unit labor costs that can occur if wage rises lag behind the increase in productivity.

On the demand side, however, a rise in the potential growth rate acts to boost aggregate demand. Therefore, a rise in the potential growth rate does not necessarily exert downward pressure on prices. The recent rise in the potential growth rate stems from firms' efforts to reallocate their resources to areas likely to generate higher profitability and growth in demand, and this implies an improvement in the overall economy's ability not only to produce goods but also to increase profits and income by selling those goods. Such real economic improvements brighten firms' and households' expectations regarding future income, and this brighter outlook, together with the wealth effect stemming from the rise in stock prices, is likely to stimulate aggregate demand by bolstering their spending. Moreover, since the expected rate of return on investment increases when the potential growth rate is rising, monetary easing effects become stronger at any given level of the real interest rate. The result is to further increase investment demand, triggering upward pressure on prices.

In terms of the time frame, a rise in the potential growth rate often causes an increase in production capacity in the relatively short term, while in the longer term it seems to bring about an increase in demand and to strengthen monetary easing effects. Such a picture, however, is inevitably attended by uncertainty, since individual economic agents may increase demand in advance, taking account of increases in their expected future income and in response to the wealth effect. Whatever the case, a rise in the potential growth rate warrants close attention as it may give an expansionary push to the economy not only from the supply side but also from the demand side, and because its effect on prices can be both upward and downward.

Conduct of Monetary Policy

I would now like to talk about the Bank's conduct of monetary policy, based on the outlook for economic activity and prices.

At the Monetary Policy Meeting held on March 8 and 9, 2006, the Bank decided to terminate the quantitative easing policy, which had been maintained during the five years since March 2001. It 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. The new target for the uncollateralized overnight call rate was set at effectively zero percent.

Under the new guideline for money market operations, the volume of short-term funds-supplying operations by the Bank has been decreasing. Accordingly, the outstanding balance of current accounts at the Bank has now declined to around 16 trillion yen. So far, the short-term money market remains stable and there is gradually more activity being seen in the interbank market. The Bank will continue to closely monitor conditions in the short-term money market in reducing the outstanding balance of current accounts at the Bank. As long as the short-term money market remains stable, the reduction in the outstanding balance will be completed in line with the projection the Bank made when it terminated the quantitative easing policy in March. However, completing the reduction of the outstanding balance of current accounts at the Bank and raising the target interest rate, which is effectively zero percent, are two different issues. While the reduction in the outstanding balance of current accounts at the Bank is carried out taking full account of conditions in the short-term money market, the level of the target interest rate is to be set based on the Bank's assessment of economic activity and price developments.

With regard to the future conduct of monetary policy based on the new operating target of money market operations, namely, the uncollateralized overnight call rate, the Bank introduced a new framework. The Bank announced that, under this framework, it would assess economic activity and prices from two perspectives, taking account of the "understanding of medium- to long-term price stability," which is expressed as an approximate range between zero and 2 percent in terms of the rate of year-on-year change in the CPI. In light of this assessment, it would outline and release its current view on monetary policy. The April Outlook Report was compiled under the new framework.

In the Outlook Report, the Bank examined, from the first perspective, whether the outlook deemed most likely by the Bank for economic activity and prices two years into the future is that the economy will follow a path of sustainable growth under price stability. The Bank judged that Japan's economy is likely to achieve sustainable growth under price stability as long as the economy develops in line with the outlook described earlier.

From the second perspective, the Bank examined the risks that are most relevant to conducting monetary policy, looking over a longer time horizon.

As a result, the Bank came to the conclusion that, as an upside risk, it should pay attention in the medium to long term to larger economic swings, resulting in large fluctuations in the rate of inflation, mainly due to acceleration of business fixed investment reflecting the accommodative financial conditions.

As for downside risks, the Bank examined the possibility of economic activity and the rate of inflation deviating downward from its projection due to various factors. The Bank's judgment was that even if economic activity is less robust and the inflation rate lower than expected, the risk of the economy falling into a vicious circle of declining prices and deteriorating economic activity has become smaller, since the Japanese financial system has regained stability and the economy has now cast off excesses in production capacity, employment, and debt.

With regard to the future course of monetary policy, based on the assessment of economic activity and prices from the two perspectives, it seems probable that the accommodative financial conditions ensuing from very low interest rates will be maintained for some time following a period in which the uncollateralized overnight call rate is at effectively zero percent. Through and beyond this stage, the Bank will adjust the level of the target interest rate gradually in the light of developments in economic activity and prices.

The Bank will continue to support the economy so as to achieve sustainable growth under price stability through the appropriate conduct of monetary policy.

Recent Economic and Financial Developments and the Conduct of Monetary Policy

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

INTRODUCTION[1]

Japan's economy continues to grow, with domestic and external demand and also the corporate and household sectors well in balance. The economy is likely to achieve sustainable growth under price stability.

Today, I will explain the background of the economic outlook and assess several risk factors influencing the outlook. Moreover, based on the review, I will talk about how the Bank will conduct monetary policy with a view to achieving sustainable growth under price stability.

Outlook for Economic Activity and Prices

I will first summarize the outlook for economic activity and prices. The Bank presented the projection of economic activity and prices for two years ahead through fiscal 2007 in its *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) released on April 28, 2006: Japan's economy is likely to experience a sustained period of expansion, with domestic and external demand and also the corporate and household sectors well in balance, and the year-on-year rate of increase in the consumer price index (CPI; excluding fresh food, on a nationwide basis) is likely to rise gradually.

The Outlook Report pointed to the following four factors as the mechanism behind the projection. First, exports are likely to continue to increase reflecting global economic expansion. Second, corporate performance is likely to continue to be strong. Third, the positive influence of corporate sector strength on the household sector is likely to become stronger. And fourth, financial conditions are likely to remain extremely accommodative.

Examining data available after the publication of the Outlook Report, developments in economic activity and prices so far seem to be in line with the projection in the Outlook Report.

As for economic activity in fiscal 2005, which is the basis of the projection for fiscal 2006 and 2007, it was confirmed that the economy had continued to grow with balanced external demand and domestic demand particularly in the private sector. Real GDP registered an annualized growth rate of 3.1 percent for the January–March quarter of 2006 and 3.2 percent for fiscal 2005. Corporate performance continued to be strong, as is evident from increases in profits both in the manufacturing and nonmanufacturing sectors at the book closing for fiscal 2005, following the large gains in the previous fiscal year. In this situation, business fixed investment both in the manufacturing and nonmanufacturing sectors showed robust growth during the January–March quarter of 2006, as shown in the quarterly *Financial Statements Statistics of Corporations by Industry*.

As for future developments in economic activity, the corporate sector is likely to remain strong. Major firms are expected to enjoy continued profit growth in fiscal 2006, which in the manufacturing sector is likely to be particularly strong in the processing industries, such as electrical machinery, general machinery, and automobiles, and in the nonmanufacturing sector in industries related to private consumption, such as retailing and services. Various surveys indicate that firms' business fixed investment plans are also relatively strong. We expect that the strength in the corporate sector will continue, but the growth in business fixed investment will gradually slow. I will elaborate on this later.

The positive influence of the strength in the corporate sector on the household sector is becoming more evident. As for employment and wages, labor market conditions have been improving on the whole. The unemployment rate has recently declined to around 4 percent from the 5–6 percent level in 2003, and the ratio of job offers to applicants has been exceeding 1.00 for the first time since 1992. In addition to the increase in the number of part-time workers, the number of full-time workers has been increasing recently due to the shortage of labor felt among firms. As for wages, regular payments have started to rise in addition to the increases in overtime and bonus payments. Although the pace of increase in wages is moderate partly due to firms' efforts to restrain labor costs, the increase is likely to continue. With the increase not only in temporary income but also in the more permanent part of income, private consumption is likely to remain strong.

Turning to prices, domestic corporate goods prices are rising, due to the surge in the prices of international commodities such as crude oil and nonferrous metals. Recently released statistics show that the year-on-year rate of increase in domestic

1. This article is excerpted and translated from a speech given by Toshihiko Fukui, Governor of the Bank of Japan, to the Japan National Press Club in Tokyo on June 20, 2006.

corporate goods prices was 3.3 percent in May, faster than the 2.5 percent increase in April. It is likely to remain high for the time being.

The year-on-year rate of increase in the CPI was 0.5 percent in April and continued to be on an uptrend. Looking at individual prices for items in the CPI basket, the number of items showing price rises is gradually increasing, and the trend toward price increases is becoming more robust. For example, prices for services, such as those for package tours, golf fees, and educational costs, have been revised upward with the start of the new fiscal year. Services prices are important indicators to confirm the general trend in prices, because their movements are largely influenced by changes in wages. Prices of items other than services, such as personal effects and clothing, are also increasing gradually.

Developments in Overseas Economies

As I explained, Japan's economy is likely to achieve sustainable growth under price stability. Domestic private demand seems to be standing on a firm foundation given that structural adjustment pressures in the corporate sector and the financial system have dissipated. This directs our attention to developments in overseas economies as one major risk factor determining the outlook for Japan's economy.

In the U.S. economy, business fixed investment and production have been increasing steadily, but signs of deceleration in housing construction have finally been observed and the pace of increase in household spending and employment has been slowing. This trend suggests that interest rate raises by the Federal Reserve to date have been gradually taking effect. The increase in the core CPI has been accelerating slightly, reflecting the rise in utilization of labor and production capacity in addition to high crude oil prices. In this situation, inflationary concerns seem to be mounting. As for developments in the near future, important issues are whether economic deceleration in the United States will result in a soft landing, and whether inflationary concerns will be contained.

In Europe, the momentum for economic recovery has been increasing gradually, as is evident from increases in exports and production and the recovery in household spending. Under these circumstances, the European Central Bank has been carefully raising its policy interest rate since 2005 in order to stave off the upward pressure on general prices from high crude oil prices and to sustain the economic expansion.

The Chinese economy has continued to show extremely high growth. Monetary policy has been tightened recently so as to deal with the expansion in the money stock and bank lending as well as high growth in business fixed investment. Whether overheating of economic activity can be contained through appropriate policy conduct is an important factor when monitoring developments not only in the Chinese economy but also the world economy, and global price developments including developments in international commodity prices.

In 2005, the world economy grew by nearly 5 percent. This expansion has been supported by the fact that a stable financial environment has been maintained by containing upward pressure on prices. A key factor in maintaining a stable financial environment is whether global inflationary concerns continue to be contained in the future.

Developments in Financial Markets

I would next like to briefly touch on recent developments in global financial markets. Stock prices have been declining in emerging economies as well as in major industrial countries. Financial markets in many emerging economies have been weak, as is evident from the falls in bond prices and foreign exchange rates in addition to stock prices. Prices of some international commodities, including those of nonferrous metals, have declined recently, after exhibiting large increases.

Market participants point to various factors behind these developments. One is the adjustment of stock and commodity prices, which had risen substantially in the prolonged accommodative financial environment around the world, in response to changes in the degree of this financial accommodation. Another factor is uncertainty as to whether inflationary risks will be contained, and whether a considerable deceleration of economic activity will be staved off even when inflationary risks are contained.

The fundamentals of economies worldwide, including Japan's, do not seem to have changed significantly so far. Under the current economic circumstances, financial markets are evolving in pursuit of a new equilibrium by digesting new information while interacting with each other. Financial market developments continue to warrant careful monitoring, since they influence economic activity through their impact on business and household sentiment.

Developments in Inventory Investment

As I mentioned earlier, domestic private demand is standing on a firm foundation, but in the corporate sector, it is necessary to pay attention to the possibility of a stock adjustment. Such adjustment involves both downside and upside risks to the outlook for economic activity in the short term: inventory adjustment, for example in IT-related sectors, is a downside risk while a further acceleration of business fixed investment is an upside risk. Given that the output gap has already closed, a further acceleration of business fixed investment should be regarded not only as an upside risk in the short term but also a factor leading to larger economic swings in the longer term as a result of a subsequent downturn.

Looking first at inventory investment, levels of inventories are still relatively low. The inventory cycle in the manufacturing sector as a whole suggests that the growth in shipments and inventories is more or less in balance. Focusing on individual industries, excess inventories, particularly of general-purpose products, had built up in the iron and steel, and chemical industries, but recently, adjustments in these industries have been coming to an end. In IT-related sectors, the level of inventories has been somewhat high, but this is basically in line with the increase in shipments, and thus unintended and excessive inventories have not been built up at the moment.

There are some factors, however, that may trigger inventory adjustments. For example, although the demand for IT-related goods is expected to continue increasing, there is a possibility of inventory adjustments for such goods occurring depending on developments in demand. This is because the supply of these goods is increasing at a rapid pace, including in the high-value-added products sector where Japanese firms have a competitive edge.

Developments in Business Fixed Investment

As mentioned earlier, a further acceleration in business fixed investment, as another possible avenue of stock adjustments, entails not only an upside risk in the short term but also a factor leading to larger economic swings in the longer term as a result of a subsequent downturn.

From a business-cycle point of view, the economic recovery appears to be reaching the mature stage and growth is projected to gradually decelerate to the potential growth rate. Although corporate performance is likely to remain strong, the growth in business fixed investment is expected to slow as the level of capital stock becomes higher with the accumulation of past investment. As a result, the driving force of economic activity will shift gradually from the corporate sector to the household sector.

The deceleration in business fixed investment is expected to stave off a build-up of capital stock and contribute to achieving a sustained period of growth. Especially given that the output gap has closed, excessive investment and stronger economic growth are likely to increase the risk of an eventual swingback.

So far, no signs of excessive investment have been observed. In the face of intense global competition, firms seem to be selective in allocating their business resources.

It is true, however, that the financial environment is extremely accommodative and gives incentives to firms to accelerate business fixed investment. Real short-term interest rates in Japan are currently negative and extremely low compared with real GDP growth currently exceeding 3 percent and an estimated growth rate of the potential output ranging from 1.5 to 2.0 percent. Moreover, the functioning of the financial system has been enhanced and private financial institutions have been maintaining a proactive lending posture. The year-on-year growth in lending by private banks turned positive in the summer of 2005 and has been on a gradual upward trend since.

Conduct of Monetary Policy in a Low-Inflation Environment

Turning to a slightly theoretical issue, until recently, the main difficulty in conducting monetary policy in a low-inflation environment has been focused on how to deal with the risk of a deflationary spiral.

In a low-inflation environment, nominal interest rates are typically low and are thus more probable to be constrained by the zero bound. Because nominal interest rates cannot be lowered below zero, real interest rates are likely to become higher than the optimal level for the economy when prices fall. That increases the risk of the economy falling into a vicious cycle of declining prices and deteriorating economic activity. In Japan, such a risk has been a matter of strong concern since the end of the 1990s. At present, this risk has become low, since the Japanese financial system has restored its stability and firms have now resolved excesses in production capacity, employment, and debt.

On the other hand, when economic activity is picking up as a result of an unprecedented monetary easing against severe economic conditions with low inflation, a central bank is required to carry out monetary policy adroitly to adjust monetary accommodation by assessing upside risks.

For example, since the inflation rate tends to exhibit strong inertia, even if the supply-demand conditions in the economy become tighter, the observed rate of inflation and inflation expectations are likely to remain anchored at a low level. In such a situation, maintaining an excessively accommodative monetary condition entails a risk of causing temporary overheating of the economy and a subsequent downturn, thereby resulting in larger swings in economic activity.

The sensitivity of the rate of inflation to changes in the output gap has tended to become weaker not only in Japan but also abroad in recent years, reflecting structural changes such as deregulation, advances in information and telecommunication technology, and the deepening of economic globalization. Since prices are becoming less sensitive in the short term, central banks are required to take appropriate measures by examining medium- to long-term risks to the economy. This suggests the need to take a forward-looking approach in the conduct of monetary policy.

A Stable Economic and Price Environment

A stable economic and price environment, once achieved by the appropriate conduct of monetary policy with a view to medium- to long-term risks, allows firms and households to make decisions more smoothly. As a result, the allocation of resources in the economy as a whole will be more efficient, and not only will short-term economic fluctuations be reduced but also the medium- to long-term growth path will be pushed up.

Looking back at real GDP trends in Japan and the United States over the past 25 years or so, we see that economies often achieve higher growth when they move in a less volatile manner. As a result of smooth economic adjustments in the early 1980s after the Second Oil Crisis, Japan's economy followed a higher trend growth path than the U.S. economy while it moved in a less volatile manner thereafter. This situation, however, was reversed after the bursting of the asset price bubble in the early 1990s, and Japan's economy experienced a decline in the trend growth path while moving in a volatile manner.

Japan's economy is now emerging from the prolonged stagnation that was an aftermath of the bursting of the asset price bubble, and is heading toward a sustainable growth path under price stability. In order to ensure this development, it is important, through the appropriate conduct of monetary policy, to minimize the volatility of business cycles and maintain a stable economic environment.

Conduct of Monetary Policy

Before concluding my speech today, I will talk about the Bank's conduct of monetary policy based on the assessment of economic activity and prices mentioned so far.

The Bank has been reducing the outstanding balance of current accounts at the Bank by paying due attention to the stability of the money market under the guideline for money market operations that encourages the uncollateralized overnight call rate to remain at effectively zero percent. Through this process, the uncollateralized overnight call rate has been stable at around zero percent, despite small temporary increases. In the call market, interest rates have shown some fluctuations reflecting market conditions and the volume of transactions has been gradually increasing. Under these circumstances, the Bank no longer finds it difficult to control the uncollateralized overnight call rate in its day-to-day operations. In this sense, the reduction of the outstanding balance of current accounts has virtually been completed.

With regard to the future course of monetary policy, the Bank will conduct monetary policy in line with the thinking described in the Outlook Report as long as developments in economic activity and prices follow the Bank's projection presented also in the Outlook Report. In other words, it seems probable that the accommodative financial conditions ensuing from very low interest rates will be maintained for some time following a period in which the uncollateralized overnight call rate is at effectively zero percent. Through and beyond this stage, the Bank will adjust the level of interest rates gradually in the light of developments in economic activity and prices. The timing of a policy change depends on developments in economic activity and prices from this time on, and there is no predetermined view regarding the future path of monetary policy at this point.

The projection in the Outlook Report, which appears to be the desirable course of the economy, that is, sustainable growth under price stability, is based on the assumption that market participants and firms have been factoring in future policy changes to some extent when making their decisions. If the economy develops in line with the projection, changing the policy interest rate in the light of developments in economic activity and prices will stave off an excess of economic activity, minimize the volatility of business cycles, and lead the economy onto a sustainable growth path. The projection suggests that economic activity is likely to slow and prices are expected to follow a moderate uptrend. Consequently, the Bank will not have to drastically adjust the policy interest rate, but, as mentioned earlier, will be able to adjust interest rates "gradually."

Of course, there is the time lag before a monetary policy action influences economic activity and prices, and it is therefore necessary to not only take the current economic and price situation into account but also look ahead to future developments. In addition, in assessing developments in economic activity and prices, it is important to pay close attention to a variety of indicators and other relevant information in order to carefully judge overall conditions of economic activity and prices rather than concentrate on just one particular indicator, such as the CPI during the period of quantitative easing.

CONCLUSION

In sum, Japan's economy continues to grow, with domestic and external demand and also the corporate and household sectors well in balance. The Bank is determined to contribute to leading Japan's economy to sustainable growth under price stability, through the appropriate conduct of monetary policy.

The Conduct of Monetary Policy under the New Framework

Speech Given by Kazumasa Iwata, Deputy Governor of the Bank of Japan

The Conduct of Monetary Policy[1]

The Bank of Japan terminated the quantitative easing policy in early March 2006, and is in the process of reducing the outstanding balance of current accounts held by financial institutions at the Bank. The outstanding balance, which was at around 30 to 35 trillion yen at the time of the termination, is currently at around 12 trillion yen.

Some market participants take the view that the pace of reduction may be too fast, and speculate that this may reflect the Bank's intention to raise the target for interest rates at an early date. Market participants expect the Bank to raise the target for interest rates at some point during fiscal 2006, and this expectation has been factored into current market rates.

The Bank, however, noted when the quantitative easing policy was terminated that it would take a few months before the outstanding balance declined to a level near the reserve requirement. The Bank's money market operations have been in line with this policy statement, and the Bank has not been accelerating the pace of reduction in order to raise the target for interest rates at an early date. It has been some time since money market transactions were conducted under normal market conditions, so that some rates have risen due to trading friction. Nevertheless, on the whole the Bank's reduction of the outstanding balance has been carried out in a stable manner.

New Framework of Monetary Policy and Policy Implementation

The conduct of monetary policy is now based on the new framework announced in March this year and on the findings from examining the risks affecting the economic outlook that are described in the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report).

Under the quantitative easing policy, monetary policy was conducted with an emphasis on the underlying trend of the core consumer price index (CPI). To be more specific, with the overnight call rate at virtually zero percent, the Bank made a commitment to maintain the quantitative easing policy until the year-on-year rate of change in the core CPI registered zero percent or higher on a sustainable basis in order to affect market expectations of the future path of interest rates.[2] This effect is referred to as the policy duration effect.

The effectiveness of the quantitative easing policy has been the focus of much debate and criticism. I believe, however, that ultimately the policy achieved its initial aims, although this took some time.

There are two reasons for this success. First, the commitment by the Bank to maintain the quantitative easing policy until the core CPI registered zero percent or higher on a sustainable basis provided an anchor for stabilizing expectations concerning future price movements.

Second, the commitment to maintain the policy helped keep relatively long-term rates as well as short-term rates at low levels by affecting expectations regarding the future path of interest rates. As a result, the burden of firms' debt was lightened, facilitating business restructuring. This restructuring increased the effectiveness of resource allocation, leading to improvements in productivity and corporate profitability, and ultimately pushed up the potential growth rate. In short, the combination of low market interest rates and the increased rate of return on corporate nonfinancial assets acted as the basic mechanism pushing the rate of change in the core CPI above zero percent.[3] It goes without saying that the Bank's ample provision of liquidity played a complementary role in stabilizing financial markets and keeping interest rates low.

The quantitative easing policy was at times criticized as being extremely risky, being likened to driving with one's eyes on the rearview mirror because the Bank relied on a price index, a lagging indicator, in conducting monetary policy.

The Bank did not rely solely on the rearview mirror, however. In October 2003, the Bank provided

1. This article is excerpted and translated from a speech given by Kazumasa Iwata, Deputy Governor of the Bank of Japan, at a meeting with business leaders in Akita on June 8, 2006.
2. The significance of modern monetary policy is more in its ability to influence market participants' expectations of future policy interest rates than in the effects of changes in the policy rate itself. Mervyn King, Governor of the Bank of England, has referred to this phenomenon, in which the effectiveness of monetary policy is enhanced by movements in market interest rates that considerably exceed those in policy rates, as the "Maradona theory of interest rates." The name derives from Argentine football legend Diego Maradona who, in the 1986 World Cup match against England, ran 60 yards in a straight line before placing the ball in the English goal. Maradona was able to run straight for the goal because the English defenders were expecting sudden darting feints. For more details, see M. King (2005), "Monetary Policy: Practice Ahead of Theory," Mais Lecture 2005.
3. Twentieth century Swedish economist Knut Wicksell developed the theory that when the actual market rate of interest exceeds the natural rate of interest (the rate at which the supply and demand for real capital are in equilibrium) deflation accelerates, while inflation accelerates when the opposite occurs.

a detailed description of its commitment to maintaining the quantitative easing policy. One of the conditions underpinning the commitment was that the Bank needed to be convinced that the prospective core CPI would not once again drop below zero percent after terminating the policy.

Following the introduction of a new framework in March, the Bank disclosed the Policy Board members' understanding of what constitutes "medium- to long-term price stability" in numerical terms. The distribution ranged between the rate of year-on-year change in the CPI of zero and 2 percent, with most members' median figures falling around 1 percent.

It is important to note here that the "understanding of medium- to long-term price stability" was not kept within the Policy Board but was disclosed to market participants and made common knowledge. In this way, the information could become a focal point of market interest and function as a catalyst in forming a consensus concerning inflation expectations.[4]

With the change in the framework, the policy anchor for price stability shifted from the commitment in terms of policy duration to the Policy Board's "understanding of medium- to long-term price stability." Furthermore, in light of the "understanding of medium- to long-term price stability," the Bank decided to examine periodically the risks facing the Japanese economy, both in the short term (one to two years) and in the medium to long term, using the findings to formulate its thinking on the future conduct of monetary policy. The Bank is thus able to implement short-term policy in a flexible and timely manner based on due assessment of economic risks.

Returning to the metaphor of driving a car, the degree of divergence in the opinions of Policy Board members regarding the destination has been made clear (increased transparency), and the Bank is back to conventional driving with a close eye on the risks ahead, ready to react quickly when necessary.

The new framework can be said to ensure transparency as well as timeliness and flexibility in two senses.

First, disclosing the Bank's thinking concerning medium- to long-term price stability has enhanced the transparency of its policy conduct, making it possible to conduct short-term monetary policy with increased flexibility.

Second, given the fact that Japan's economy is in transition away from deflation and that structural changes continue to take place in the economy, a review of the Policy Board's "understanding of medium- to long-term price stability," to be conducted once a year as a rule, will enable a more flexible response to changes in the economic outlook and ensure the transparency and flexibility of the Bank's monetary policy.

In short, the new framework has articulated specific measures for realizing the principle of monetary policy stipulated in Article 2 of the Bank of Japan Law: to contribute "to the sound development of the national economy" "through the pursuit of price stability."

The key point here is that by stabilizing inflation expectations in the medium to long run, flexibility in conducting monetary policy in the short run has been increased, and this in turn has made it easier to achieve the objective of sustainable growth under price stability.

The "understanding of medium- to long-term price stability" is different from the Bank of England's inflation target or the European Central Bank's quantitative definition of price stability, and is an important first step toward the optimal monetary policy for realizing the principle stipulated in Article 2 of the Bank of Japan Law.

The Policy Interest Rate: The Basis for Producing Forecasts

In the most recent Outlook Report, the economic forecasts of Policy Board members were made taking account of market participants' expectations of future policy rates, which were deduced from market interest rates.[5] Under the quantitative easing policy, it was natural to base forecasts on the assumption that the

4. Two game theorists who were awarded the 2005 Nobel Prize in Economic Sciences emphasized the possibility that common knowledge could generate consensus building. This is because common knowledge, by becoming a focal point for people's interest, has the potential to alter their behavior. For more details, see K. Iwata and M. Fukao (1995), "*Keizai Seido no Kokusaiteki Chosei* (International Adjustment of Economic Systems)," Nihon Keizai Shimbun, Inc.; T. Schelling (1960), "The Strategy of Conflicts," Harvard University Press; and R. Aumann (1976), "Agreeing to Disagree," Annals of Statistics, 4.

5. In making forecasts, assumptions about the policy interest rate fall into three classes. In the first, a constant interest rate path is assumed. In the second, the interest rate path is assumed to be in line with market expectations. And in the third, interest rates are assumed to follow the optimal path projected by the central bank based on the information available to it. The Bank of England carries out forecasts using the first two approaches. The third approach is adopted by the central banks of New Zealand and Norway. For more details on Norway, see J. F. Qvigstad (2005), "When Does an Interest Rate Path 'Look Good'? Criteria for an Appropriate Future Interest Rate Path."

policy interest rate would be constant until at least the year-on-year rate of change in the core CPI registered zero percent or higher on a sustainable basis. Under the current framework, however, this assumption would be rather unnatural. Prices of assets, such as stocks and land, incorporate expected future movements in interest rates. Therefore, the assumption of constant interest rates would generate a forecast based on asset prices that differ from those currently observed. It goes without saying that ignoring actual asset prices when making forecasts is highly counterintuitive.

This does not of course imply that Policy Board members base their economic forecasts directly on the market's forecast of the policy interest rate. Mechanically adopting market forecasts of interest rate developments in conducting monetary policy and preparing forecasts might cause economic and price developments to diverge from the Bank's desired path. The new method does, however, take into account market expectations in making economic forecasts, and thus its adoption is another important step toward achieving an optimal monetary policy.

CONCLUSION

Against a background of high crude oil prices, major countries around the world are in the process of economic adjustment, aiming for a soft landing near the potential growth rate while maintaining stable prices. Financial markets around the world also are making adjustments, reflecting changes in the economy as they seek a new equilibrium. The Japanese economy has so far been moving in line with the forecast described in the April Outlook Report. Although various risks lie ahead, Japan's economy is likely to achieve sustainable growth under price stability. I believe, however, that in order to make this happen, it is vital that monetary policy is implemented appropriately so that the full potential of the new policy framework can be realized.

Publications of the Monetary Policy Meeting on April 10 and 11, 2006

Minutes

Released on May 24, 2006

The Bank's View of Recent Economic and Financial Developments

Released on April 11, 2006

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

MINUTES OF THE MONETARY POLICY MEETING ON APRIL 10 AND 11, 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 Monday, April 10, 2006, from 2:00 p.m. to 3:47 p.m., and on Tuesday, April 11, from 8:59 a.m. to 12:43 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. M. Amamiya, Director-General, Monetary Affairs Department
Mr. M. Ayuse, Deputy Director-General, Monetary Affairs Department[4]
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. 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. Y. Yamada, Director, Monetary Affairs Department[4]
Mr. K. Masaki, Senior Economist, Monetary Affairs Department
Mr. N. Takeda, Senior Economist, Monetary Affairs Department
Mr. T. Sakamoto, Director, Financial Markets Department[4]

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

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 March 8 and 9, 2006.[6] The uncollateralized overnight call rate was stable at effectively zero percent throughout the intermeeting period, including the last business day of fiscal 2005. Meanwhile, the outstanding balance of current accounts at the Bank was at around 30 trillion yen in March, but decreased gradually from the beginning of April. It was slightly less than 26 trillion yen recently.

B. Recent Developments in Financial Markets

Interest rates on term instruments, particularly the relatively longer-term rates, rose.

Japanese stock prices rose against the background of a further improvement in business sentiment, reflecting favorable economic indicators, and steady

1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on May 18 and 19, 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 April 11.
3. Mr. K. Sugimoto was present on April 10.
4. Messrs. M. Ayuse, Y. Yamada, and T. Sakamoto were present on April 11 from 8:59 a.m. to 9:16 a.m.
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 encourage the uncollateralized overnight call rate to remain at effectively zero percent.

developments in overseas stock prices. The Nikkei 225 Stock Average was recently moving at around 17,500 yen.

Long-term interest rates rose against the background of firm Japanese stock prices, developments in overseas long-term interest rates such as those in the United States, and various views regarding the future conduct of monetary policy. They were moving in the range of 1.8–1.9 percent recently.

The yen fluctuated somewhat against the U.S. dollar, partly due to market participants' speculation about the future conduct of monetary policy in Japan and the United States. 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.

In the euro area, although the economy remained somewhat sluggish, the momentum for recovery had been gradually increasing as evidenced by the recovery in exports and production partly due to the effects of the 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 against the background of growing market expectations of higher policy interest rates. Stock prices were more or less flat in the United States, while in Europe they rose. In financial markets in many emerging economies, although there were some constraints such as uncertainty regarding the future conduct of monetary policy by the Federal Reserve, the financial environment improved supported by firm economic fundamentals.

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 recently posted a sizeable gain, largely in exports of automobile-related goods. Exports to China had been increasing appreciably since the second half of 2005. 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, according to the March *Tankan* (Short-Term Economic Survey of Enterprises in Japan), corporate profits had been high and business sentiment had remained favorable. In this situation, 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 because firms were more aware of the shortage of labor and corporate profits were expected to remain high.

Private consumption had been on an increasing trend. The number of new passenger-car registrations had generally 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 uptrend, although they had recently declined marginally as a reaction to the previous rise, 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 on average against the background of the growth in domestic and external demand, although industrial production had decreased in February from the previous month. 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, taken as a whole, 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) had been on a positive trend, recording 0.5 percent in February for the second consecutive month. As for the outlook, the year-on-year rate of change in the

CPI was projected to continue 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 accommodative. The issuing environment for CP and corporate bonds was favorable, and the lending attitude of private banks was becoming more accommodative. According to the March *Tankan*, the lending attitude of financial institutions as perceived by firms and the financial positions of firms had also been improving moderately. The decline in credit demand in the private sector was coming to a halt. Meanwhile, funding costs for firms had risen slightly.

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

II. Introduction of Funds-Supplying Operations against Pooled Collateral

A. Staff Proposal

With a view to facilitating money market operations by making bill purchasing operations paperless, the staff proposed that the Bank establish Principal Terms and Conditions for Funds-Supplying Operations against Pooled Collateral in order to introduce such operations.

B. Discussion by the Policy Board and Vote

Members voted unanimously to approve the proposal and agreed that the decision should be made public.

III. 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 continue to recover steadily as a virtuous cycle of production, income, and expenditure operated, 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, although there were signs of deceleration in housing sales, 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 price developments that, in a situation where the labor market continued to tighten and the capacity utilization rate remained high, attention should be paid to the risk of a heightening of inflationary pressure reflecting the rise in commodity prices including crude oil prices.

With regard to East Asian economies, members agreed that both domestic and external demand continued to expand strongly in China. One member noted that the U.S. trade deficit with China continued to expand and China's foreign exchange reserves continued to increase, and said that the future foreign exchange policy of the Chinese authorities warranted attention.

Some members commented on risk factors for the global economy that long-term interest rates were on a rising trend not only in the United States but globally, against the background of the rise in international commodity prices, particularly crude oil prices, and the concomitant heightening of inflation expectations.

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 been on an increasing trend as strong corporate performance was benefiting 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. A few members said that, according to the March *Tankan*, business fixed investment plans for fiscal 2006 were at around or slightly above the level of those at the same time in the previous fiscal year regardless of industry or size of firm, and expressed the view that business fixed investment was likely to continue increasing steadily. Some members commented that the rate of increase in business fixed investment was still somewhat modest relative to the high level of corporate profits and of cash flow, and firms were basically maintaining their cautious investment stance. They continued that this cautious business stance of firms would support sustainable economic growth by preventing an excessive buildup of capital stock. One member said that, in a situation where the extremely accommodative financial environment continued, business fixed investment by small nonmanufacturers, which were sensitive to interest rates, warranted attention.

Members agreed that production had continued to increase on average, although it had decreased in February from the previous month, and that it was likely to increase further against the background of the growth in domestic and external demand.

Some members said that, although demand for IT-related goods was expected to continue increasing, developments in the inventory cycle suggested that slight adjustments in production and inventories might be made. From this viewpoint, one of these members added that particular attention should be paid to the balance between shipments and inventories of electronic parts and devices.

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 were more aware of the shortage of labor. On this point, one member said that it was noteworthy that large firms with favorable corporate performance in particular, such as automobile manufacturers, had agreed to a raise for the first time in several years in the wage negotiations between labor and management in spring 2006.

Members concurred that private consumption had been on an increasing trend, and was likely to continue to recover steadily, partly against the background of a gradual increase in household income. A few members noted that the diffusion index for business conditions in industries related to private consumption such as retailing and also restaurants and accommodations in the March *Tankan* was favorable, suggesting firmness in private consumption. One member said that sales of luxury goods had been favorable, and this might have been due to the rise in stock prices and the increase in dividends. A different member expressed the view, however, that the recovery in private consumption was firm but not very strong, given that there was a polarization of sales toward expensive goods and low-priced goods and that the recovery in outlays for services was limited to certain industries.

Many members expressed their views on the output gap and the potential growth rate of Japan's economy. Some members said that the output gap seemed to have closed, noting that, according to the March *Tankan*, the perception among firms of having excess production capacity had dissipated for the first time since the bursting of the bubble and firms were more aware of the shortage of labor. One member said that the past trend of total factor productivity and utilization rates of production capacity and labor was generally used in estimating potential output. However, given the recent changes in the economic structure, there was a risk of underestimating potential output with a past trend that included the period from the 1990s when the economy was sluggish. On this point, a few members said that implications for the outlook for economic activity and prices and the future conduct of monetary policy would differ depending on the view taken regarding the potential growth rate and its background.

Based on these discussions, members concurred that it was necessary to have in-depth discussions about the output gap and the potential growth rate in view of the upcoming *Outlook for Economic Activity and Prices* (hereafter the Outlook Report).

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.

Many members noted that the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) in February had registered 0.5 percent for the second consecutive month, and that the year-on-year rate of change in the CPI, excluding special factors such as petroleum product prices and electricity and telephone charges, had also continued to be positive. One member pointed out that the uptrend in imputed rent, which had recently been contributing greatly to the increase in the CPI year on year, was likely to continue, and said that prices were clearly on an improving trend.

With regard to the outlook for the year-on-year rate of change in the CPI, members agreed that it was likely to continue to follow a positive trend, albeit with some fluctuations, based on the following points. First, the output gap was likely to continue narrowing gradually against the background of the continuing steady recovery in the economy. And second, downward pressures from unit labor costs were likely to weaken with the rise in wages. Some members commented on price developments for the immediate future that the effects of the revision of services prices made at the turn of the fiscal year should be closely monitored. One member said that, according to the March *Tankan*, the diffusion index for firms' perception of changes in output prices was improving, particularly among nonmanufacturers and small firms, and expressed the view that firms were starting to pass on higher costs in sales prices. Against this view, one member said that it should be borne in mind that manufacturers continued to have difficulty in passing on higher costs as international price competition was intensifying.

Regarding published land prices data, a few members said that, in the three major metropolitan areas (Tokyo, Osaka, and Nagoya), commercial land prices had increased for the first time in 15 years and the rate of decline in residential land prices had diminished markedly, while land prices in non-metropolitan areas remained on a downward trend. On this basis, they expressed the view that, although large increases in land prices had been observed in some parts of central Tokyo, taken as a whole the formation of land prices was generally consistent with the expected return.

B. Financial Developments

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

A few members pointed out that U.S. long-term interest rates had risen against the background of the following factors: the growing uncertainty about the future conduct of monetary policy in a situation where the policy interest rate seemed to be approaching a neutral level; and persisting concerns about inflation.

Some members commented on the fact that Japanese long-term interest rates had been rising and their volatility had increased somewhat since the previous meeting. They expressed the view that this was due not only to domestic factors such as firm Japanese stock prices reflecting a further improvement in business sentiment and various views regarding the future conduct of monetary policy, but also to the rise in long-term interest rates overseas, for example, in the United States. A few of these members noted that interest rates on instruments with medium-term maturities were rising noticeably and said that this to some extent reflected market participants' speculation about the future conduct of monetary policy.

Some members pointed out that, according to the March *Tankan*, the financial positions of firms and the lending attitude of financial institutions as perceived by firms had continued to improve both at large and small firms, and expressed the view that the environment for corporate finance had remained accommodative as before the termination of the quantitative easing policy. One member said that the Bank should examine carefully the financial environment including developments in funding costs for firms such as lending rates and issuance rates of CP and corporate bonds, in addition to developments in availability and volume of funds.

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

On the monetary policy stance for the immediate future, members agreed that, based on their assessment of the economic and financial situation, it was appropriate to maintain the current guideline for money market operations that the Bank would encourage the uncollateralized overnight call rate to remain at effectively zero percent.

Members concurred that developments in the money market since the termination of the quantitative easing policy, including the last business day of fiscal 2005, had been stable. They agreed that the Bank would continue to closely monitor conditions in the money market in reducing the outstanding balance of current accounts at the Bank. One member expressed the view that the pace of reduction would depend on conditions in the money market in the immediate future, and if the money market continued to be stable, it was likely that the reduction of the current account balance toward a level in line with required reserves would be realized over a period of a few months as planned. A different member said that there had been growing speculation among market participants that the zero interest rate policy would be terminated earlier than expected, and thus there was a risk that such speculation would increase further if the Bank reduced the current account balance too rapidly.

Members discussed the Bank's communication of its thinking concerning the conduct of monetary policy.

Members concurred that, taken as a whole, developments in financial markets since the termination of the quantitative easing policy had been stable, and understanding of the Bank's thinking concerning the conduct of monetary policy had been gradually spreading among market participants. Many members said that the Bank should further promote market participants' understanding of the new framework for the conduct of monetary policy.

Some members said that some market participants seemed to have misunderstood that the level of inflation referred to as "an understanding of medium- to long-term price stability" was directly related to the timing of a change in the Bank's monetary policy. These members said that the Bank should therefore promote market participants' understanding that the "understanding of medium- to long-term price stability" was the level of inflation each member currently understood as price stability which they would bear in mind in making decisions regarding the conduct of monetary policy and that it was not an inflation target or a numerical definition of price stability. On this point, a few members said that the Bank should explain that it was important to understand the three elements of the new framework for the conduct of monetary policy—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—as a whole. One member stressed that the "understanding of medium- to long-term price stability" could function as an anchor for price stability by ensuring both transparency and flexibility of monetary policy, and consequently, the Bank would be able to conduct monetary policy flexibly in the short term in response to developments in economic activity and prices.

One member said that, with regard to the Bank's thinking that the rate of inflation at which households and firms perceived price stability might be low because Japan's average rate of inflation had been lower in the past than that of major overseas economies, a criticism had been expressed that the Bank did not understand the forward-looking expectations formation mechanism. This member presented an empirical analysis which showed that in Japan perception of price stability was formed to a large extent in a backward-looking manner, based on past experience, and noted that pursuing an inflation rate that deviated from expectations formed in this way would carry a risk of causing a misunderstanding that the Bank was trying to induce higher inflation. The member continued that the backward-looking expectations could change over a relatively short period of time reflecting changes in the economic structure, and thus it was important to review the "understanding of medium- to long-term price stability" regularly.

Some members commented on a criticism that the new framework for the conduct of monetary policy lacked clarity compared with the Bank's commitment under the quantitative easing policy. They expressed the view that, under an interest rate policy, communication between market participants and the Bank should be changed from the one-way communication seen in the Bank's commitment under the quantitative easing policy to a dynamic two-way communication via market interest rates. On this point, one member said that the following interaction between the Bank and market participants would constitute the basis for communication under an interest rate policy. First, the Bank would present its basic thinking concerning the conduct of monetary policy and its assessment of economic activity and prices. Second, market participants would make transactions based on their views regarding interest rates, taking into account the Bank's basic thinking and its assessment. And third, the Bank would obtain important information on market participants' views from developments in financial markets.

With regard to the future path of monetary policy, members agreed that it was important to explain fully that, 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 probably be maintained for some time, as indicated in the public statement released when the quantitative easing policy was terminated. On this point, some members said that the Bank should be careful in its communication, given that market participants were keenly interested in the future course of monetary policy.

V. Remarks by Government Representatives

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

(1) Japan's economy was recovering. A comprehensive review of developments in prices suggested that, although moderate deflation persisted, the price situation was improving gradually, as evidenced by, for example, the recently released year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) for February recording 0.5 percent. The government considered that it was necessary to ensure that this improvement continued.
(2) The government would like the Bank to firmly support the economy from the financial side by maintaining a zero interest rate environment in order to ensure the overcoming of deflation and prevent the economy from weakening again, taking fully into account that ensuring the sustainability of the economic recovery and overcoming deflation were important policy tasks.
(3) The government would also like the Bank, as the central bank, to ensure market stability by carefully lowering the outstanding balance of current accounts at the Bank taking into account developments in the market and closely monitoring developments in overall interest rates including long-term interest rates.
(4) The government understood the Bank's unanimous decision regarding the Bank's view on monetary policy conduct at the previous Monetary Policy Meeting that, if it was judged that inflationary pressures were restrained, an accommodative monetary environment ensuing from very low interest rates would probably be maintained for some time. However, the message regarding the future path of monetary policy decided by the Bank seemed to have been misunderstood by some market participants, as could be seen in the fact that short- and medium-term interest rates had risen due to speculation that the Bank would begin a series of interest rates rises in the near future. The government would therefore like the Bank to ensure market stability by explaining its view on monetary policy conduct clearly to market participants and the public in line with the decision made at the previous Monetary Policy Meeting.

The representative from the Cabinet Office made the following remarks.

(1) Japan's economy was recovering. However, a comprehensive review of developments in prices suggested that moderate deflation persisted, although the price situation had been showing some improvement. 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 Bank had been maintaining an accommodative financial environment by encouraging the uncollateralized overnight call rate to remain at effectively zero percent since the termination of the quantitative easing policy, taking consistency with the government's basic policy for the economy fully into consideration. The government would like to request that the Bank, in its future conduct of monetary policy, continue its policy efforts to overcome deflation together with the government and support the economy from the financial side responsibly.
(3) Given the Bank's new framework for the conduct of monetary policy introduced at the previous Monetary Policy Meeting, the government hoped that the Bank would explain more clearly its view on economic activity and prices and its outlook, as well as the relationship between these and the overcoming of deflation via, for example, the April Outlook Report, in order to make it easier for market participants and the public to form an economic outlook and stabilize their expectations.

VI. Votes

Based on the above discussions, members agreed that it was appropriate to maintain the current guideline for money market operations, which encouraged the uncollateralized overnight call rate to remain at effectively zero percent.

To reflect this view, <u>the chairman</u> formulated the following proposal and put it to the vote.

The Chairman's Policy Proposal on the Guideline for Money 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 encourage the uncollateralized overnight call rate to remain at effectively zero percent.

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

Votes against the proposal: None.

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 April 11, 2006 and the whole report on April 12, 2006.[7]

VIII. Approval of the Minutes of the Monetary Policy Meeting

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of March 8 and 9, 2006 for release on April 14, 2006.

Attachment

April 11, 2006
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by unanimous 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.

7. The English version of the whole report was published on April 13, 2006.

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

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 and favorable business sentiment. Household income has also continued rising moderately, reflecting the improvement in employment and wages. In this situation, private consumption has been on an increasing trend. Housing investment has shown some strength. Meanwhile, public investment has been on a downtrend.

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

The level of economic activity has risen, as evidenced by the fact that various excesses have virtually been eliminated, and firms are more aware of the shortage of labor. Furthermore, in the period ahead, 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. 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 change in consumer prices (excluding fresh food) has been on a positive trend.

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 continue 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 accommodative. The issuing environment for CP and corporate bonds is favorable. Also, the lending attitude of private banks is becoming more accommodative. 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. Funding costs for firms have risen slightly. Meanwhile, the year-on-year growth rate of the money stock has been at the 1.0–2.0 percent level. As for developments in financial markets, in the money markets, the overnight call rate has been effectively zero percent under the Bank of Japan's guideline for money market operations. Interest rates on term instruments, particularly the relatively longer-term rates, have risen compared with last month. 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 been around the same level as last month.

8. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 10 and 11, 2006. It is based on information available at the time of the meeting.

Publications of the Monetary Policy Meeting on April 28, 2006

Minutes

Released on June 20, 2006

Outlook for Economic Activity and Prices: The Bank's View

Released on April 28, 2006

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

MINUTES OF THE MONETARY POLICY MEETING ON APRIL 28, 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 Friday, April 28, 2006, from 9:00 a.m. to 12:39 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
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. M. Amamiya, 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[2]
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. K. Kamiyama, Senior Economist, Monetary Affairs Department

I. Summary of Staff Reports on Economic and Financial Developments[3]

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 April 10 and 11, 2006.[4] The uncollateralized overnight call rate was stable at effectively zero percent. The outstanding balance of current accounts at the Bank decreased gradually, and was at around 20 trillion yen recently.

B. Recent Developments in Financial Markets

In the money market, interest rates on term instruments had stopped rising and had been more or less flat. Long-term interest rates were moving at around 1.9 percent recently. Japanese stock prices declined, partly reflecting an appreciation of the yen against the U.S. dollar, in a situation where market concern about the high level of stock prices was increasing. The Nikkei 225 Stock Average was recently moving at around 17,000 yen. The yen had appreciated against the U.S. dollar, and was being traded in the range of 114–115 yen recently.

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 business fixed investment and private consumption, although housing investment was decelerating gradually. In the euro area, although the economy

1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on June 14 and 15, 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. Momma was present from 9:50 a.m. to 12:39 p.m.
3. Reports were made based on information available at the time of the meeting.
4. The guideline was as follows:
The Bank of Japan will encourage the uncollateralized overnight call rate to remain at effectively zero percent.

remained somewhat sluggish, the momentum for recovery had been gradually increasing as evidenced by the recovery in exports and production. 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 speculation about the Federal Reserve's monetary policy for the near future. Stock prices in the United States and Europe rose, partly due to some firms' favorable earnings reports. With regard to financial markets in many emerging economies, the financial environment improved supported mainly by firm economic fundamentals.

D. Economic and Financial Developments in Japan

1. Economic developments

Exports had continued to increase at a relatively high pace since the second half of 2005 against the background of the expansion of overseas economies. They recorded 3.4 percent quarter-on-quarter growth in the January–March quarter of 2006.

The *Annual Survey of Corporate Behavior (Fiscal 2005)* conducted by the Cabinet Office showed that firms expected real economic growth to be close to 2 percent, and it also suggested that their attitude toward business fixed investment and employment was positive. According to the survey conducted by the Japan Finance Corporation for Small and Medium Enterprise in March, the proportion of small firms that had carried out business fixed investment was at a high level for both manufacturers and nonmanufacturers.

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. Private consumption remained on an increasing trend on average, although some indicators, including sales at department stores and at supermarkets, dropped back in the January–March quarter, after having posted strong sales in the previous quarter.

Industrial production increased only modestly in the January–March quarter, recording 0.6 percent quarter-on-quarter growth. It was, however, expected to show steady growth in the April–June quarter. Inventories, taken as a whole, had been more or less in balance with shipments.

Domestic corporate goods prices had continued to increase, mainly reflecting the rise in prices of international commodities, such as crude oil and nonferrous metals. The year-on-year rate of change in the consumer price index (CPI; excluding fresh food, on a nationwide basis) had been on a positive trend, recording 0.5 percent in March. As for the outlook, the year-on-year rate of change in the CPI was projected to continue to follow a positive trend, albeit with some fluctuations, as supply-demand conditions continued improving gradually. The preliminary figure for the year-on-year rate of change in consumer prices (excluding fresh food) in the Tokyo metropolitan area increased slightly to 0.3 percent in April, led by services prices.

2. Financial environment

The environment for corporate finance was accommodative. The issuing environment for CP and corporate bonds was favorable, and the lending attitude of private banks was becoming more accommodative. The decline in credit demand in the private sector was coming to a halt. Meanwhile, funding costs for firms had risen slightly.

The year-on-year growth rate 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. A few members expressed the view that economic activity in fiscal 2005 seemed to have been stronger than the projection in the October 2005 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report).

Members agreed that overseas economies, particularly those of the United States and East Asia, continued to expand. A few members noted that projections for world economic growth by, for example, international organizations had been revised upward. On the U.S. economy, some members pointed out that some indicators, such as retail sales and the consumer confidence index, were stronger than expected, although housing investment was decelerating gradually. Some members said that, although the Chinese economy continued its high growth, it should be watched for signs of overheating. Many members commented that as prices of international commodities, such as crude oil and nonferrous metals, remained at high levels, attention should continue to be paid to developments in these prices and to their effects on financial markets and economic activity.

Members concurred that Japan's exports had continued to increase against the background of these developments in overseas economies.

With regard to developments in the corporate sector, a few members pointed out that firms remained cautious about future developments in demand, according to the *Annual Survey of Corporate Behavior (Fiscal 2005)* conducted by the Cabinet Office. A few members said that some firms had been unable to pass on higher production costs resulting from the rise in crude oil prices, and attention should be paid to the effects on corporate profits. One member commented that although it was true that corporate profits had been strong, it should be noted that the figures included profits from overseas business operations. The member continued that firms were relatively active in making business fixed investment abroad, but they had been cautious at home.

As for the household sector, many members expressed the view that private consumption remained steady in a situation where labor market conditions had continued to improve. One member pointed out that, although private consumption was on an increasing trend, related indicators for the January–March quarter were somewhat sluggish, and this might be partly in reaction to the strong previous quarter.

Most members agreed that domestic corporate goods prices had continued to increase due mainly to the effects of the rise in prices of commodities, in particular crude oil, at home and abroad. Many members commented that a positive trend in consumer prices was becoming clear, as evidenced by the fact that the preliminary figure for the year-on-year rate of change in consumer prices in the Tokyo metropolitan area rose slightly in April led by revisions of services prices, such as education expenses, at the beginning of the new fiscal year.

A few members said that it was confirmed in the *Regional Economic Report*, which was released in the middle of April, that the economy remained on a recovery trend in most regions, although there were differences in the degree of improvement.

B. Financial Developments

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

Regarding developments in financial markets, some members said that long-term interest rates, which were on an upward trend worldwide, warranted careful monitoring. Some members pointed out that the U.S. dollar had been depreciating against the yen recently, partly reflecting market participants' concern about issues relating to the renminbi and global imbalances, and thus future developments in the foreign exchange market and their effects should be watched carefully.

C. Outlook for Economic Activity and Prices

With regard to the outlook for economic activity and prices, members agreed on the following assessment: Japan's economy was likely to experience a sustained period of expansion, with domestic and external demand and also the corporate and household sectors well in balance over the course of fiscal 2007. Some members said that the level of economic activity was becoming relatively high recently, and "expansion" would be an appropriate term to describe future developments if the economy continued to grow.

Members pointed out the following as the background to their economic outlook. First, exports were likely to remain on the increase, reflecting the continuing expansion of overseas economies. Second, corporate performance was likely to continue to be strong even with the effects of high crude oil prices factored in. Third, strong corporate performance was likely to continue benefiting the household sector. And fourth, the extremely accommodative financial conditions were likely to support private demand.

Many members expressed the view that, given that the current recovery of the economy had already lasted for four years and three months, the growth rate was likely to slow gradually toward the potential growth rate as the current recovery of the economy matured. One member elaborated on this point, saying that although the strength in the corporate sector was likely to continue, the growth in business fixed investment was expected to fall off gradually due to the capital stock cycle. The member continued that the driving force of economic recovery would shift from the corporate sector to the household sector, and thus a virtuous circle was likely to be maintained.

Regarding the output gap and the potential growth rate, members agreed on the following points based on new estimates. First, the output gap in the economy had closed. And second, the potential growth rate had risen to the 1.5–2 percent range partly because the "three excesses" in the corporate sector were almost resolved and resources were being allocated more efficiently. One member said that, since Japan's economy was in the process of returning to a sustainable growth path after a prolonged adjustment phase, uncertainties pertaining to the estimation of the output gap and the potential growth rate on a real time basis should be borne in mind.

With regard to prices, members agreed that, given this economic outlook, the environment for prices would continue to improve, as it was likely that the output gap would improve gradually and downward pressures from declining unit labor costs would weaken. Members concurred that domestic corporate goods prices had been exceeding the October projection, reflecting higher international commodity prices and the weaker yen in the second half of 2005, and were likely to continue increasing. Members agreed that the year-on-year rate of increase in the CPI was likely to gradually rise.

Members said that they had made their economic forecasts based on a new assumption that policy interest rates were time-variant, referring to market interest rates. They agreed that this would ensure consistency with developments in other financial variables, such as long-term interest rates and stock prices, on which members based their forecasts. One member said that, in order for this new assumption to be beneficial, it was important to avoid possible misunderstanding that the Bank was committed to conducting monetary policy based on a specific policy interest rate path.

With regard to upside and downside risks to the above outlook, members raised the following three points in relation to economic activity: the growth path of the global economy; the possibility of inventory adjustments; and an acceleration of business fixed investment. They also raised the following three risks to prices: the impact of the emerging positive output gap; the path of the prices of crude oil and other international commodities; and the impact of an increase in the potential growth rate.

As for the growth path of the global economy, many members warned that there was a risk that overseas demand would deviate downward from the outlook due partly to a rise in long-term interest rates. One of these members said that the direct impact of the rise in crude oil prices on Japan's economy was expected to be limited, as its energy efficiency was high. However, attention should be paid to the indirect effects via overseas economies, because the rise in crude oil prices was fundamentally a reflection of an increase in demand worldwide and crude oil prices were likely to remain at high levels. A few members commented that growth of the world economy had been stronger than expected, and risks of upward deviation from the outlook should also be noted.

Some members said that attention should be paid to the risk of inventory adjustments materializing in the future, given the basic scenario that the current economic recovery was likely to mature and the uncertainty regarding developments in IT-related demand. However, the impact of possible inventory adjustments on the overall economy would probably not be significant.

With regard to an acceleration of business fixed investment, a few members said that in the October 2005 Outlook Report the Bank described it as an upside risk to the outlook, but in the April 2006 Outlook Report it should mention not only the upside risk but also a risk of a subsequent slowdown, given that the output gap had already closed. They added that, since developments in business fixed investment could be significantly affected by the accommodative financial environment, an acceleration of business fixed investment should be noted as one of the risks that were most relevant to the conduct of monetary policy, in terms of the second of the two perspectives in the new framework for monetary policy introduced in March 2006.

As for the outlook for prices, some members said that the sensitivity of prices to changes in the output gap was currently weak, partly reflecting globalization, but the expected inflation rate might be revised upward as the output gap became positive in the future. A few members commented that, if the potential growth rate increased, continued momentum for economic expansion might not give rise to inflationary pressure immediately due to downward pressure on prices from the supply side.

Regarding the conduct of monetary policy, members assessed economic activity and prices from the two perspectives. In terms of the first perspective, which concerned the outlook deemed most likely by the Bank for economic activity and prices two years in the future, members agreed that Japan's economy was likely to achieve sustainable growth under price stability.

Members then exchanged views in terms of the second perspective, which was examining risks that were most relevant to conducting monetary policy, looking over a longer time horizon. Many members expressed the view that an accommodative monetary environment would probably be maintained for some time, and in this situation, the stimulus from monetary policy to economic activity and prices might be amplified and there was a risk in the medium to long term of larger economic swings, resulting in large fluctuations in the rate of inflation. A few members commented that, even if economic activity was less robust and the inflation rate lower than expected, the risk of the economy falling into a vicious circle of declining prices and deteriorating economic activity had become smaller, since the Japanese financial system had regained stability and the economy had now cast off excesses in production capacity, employment, and debt.

With regard to the future course of monetary policy, as a result of the assessment of economic activity and prices described above, members concurred that the Bank should explain the following points clearly. First, it seemed probable that the accommodative financial conditions ensuing from very low interest rates would be maintained for some time following a period in which the uncollateralized overnight call rate remained at effectively zero percent. And second, through and beyond this stage, the Bank would adjust the level of interest rates gradually in the light of developments in economic activity and prices. One member said that, although these two points were essentially identical to what was explained at the time of the termination of the quantitative easing policy, it would be worthwhile to give the same message based on the assessment of economic activity and prices over the course of fiscal 2007.

Some members commented that it should be noted that market participants tended to pay keen attention to the Bank's next policy action. They continued that, under the new framework, it was important for the Bank to describe carefully its assessment of the outlook for economic activity and prices from the two perspectives and present a consistent stance on the conduct of monetary policy in a transparent and timely manner, as this would contribute to stabilizing the expectations of market participants and the public.

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

On <u>the monetary policy stance for the immediate future</u>, members agreed that, based on their assessment of the economic and financial situation, it was appropriate to maintain the current guideline for money market operations that the Bank would encourage the uncollateralized overnight call rate to remain at effectively zero percent.

Some members said that, although the outstanding balance of current accounts at the Bank had decreased to around 20 trillion yen without any major disruption, the Bank should continue to closely monitor conditions in the money market in reducing the outstanding balance of current accounts.

IV. Remarks by Government Representatives

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

(1) Japan's economy was recovering. A comprehensive review of developments in prices suggested that, although moderate deflation persisted, the price situation was improving gradually. The government considered that it was necessary to ensure that this improvement continued.

(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. All possible efforts should be made to ensure the overcoming of deflation and prevent the economy from weakening again, and thus the government would like the Bank to firmly support the economy from the financial side by maintaining a zero interest rate environment.

(3) The government considered that, in order to ensure market stability, the Bank, as the central bank, needed to be more careful in lowering the outstanding balance of current accounts at the Bank, which was currently at around 20 trillion yen, and also closely monitor developments in overall interest rates including long-term interest rates.

(4) The April Outlook Report, whose text would be decided at the meeting, had been attracting

attention because it would be the first since the Bank's introduction of the new framework for the conduct of monetary policy in March. In order to prevent financial markets from becoming unstable due to various speculations regarding the future conduct of monetary policy, the government would like the Bank to explain its view clearly to market participants and the public in line with its thinking concerning the future course of monetary policy in the April Outlook Report.

The representative from the Cabinet Office made the following remarks.

(1) Japan's economy was recovering. However, a comprehensive review of developments in prices suggested that moderate deflation persisted, although the price situation had been showing some improvement. 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) Concerning the April Outlook Report, the Policy Board members had discussed the outlook for economic activity and prices two years into the future, and concurred that Japan's economy was likely to continue expanding with balanced domestic and external demand and that it was likely to achieve sustainable growth under price stability. However, crude oil prices, which were at high levels, could have adverse effects not only on overseas economies, but also on Japan's economy. The government considered that, although the economy's excess supply had mostly been eliminated, careful attention should be paid to downside risks to economic activity and prices.

(3) The Bank had been maintaining an accommodative financial environment by encouraging the uncollateralized overnight call rate to remain at effectively zero percent since the termination of the quantitative easing policy, taking consistency with the government's basic policy for the economy fully into consideration. The government would like to request that the Bank, in its future conduct of monetary policy, continue its policy efforts to overcome deflation together with the government and support the economy from the financial side responsibly.

(4) To prevent the financial markets from becoming unstable after the release of the April Outlook Report due to speculation regarding the future conduct of monetary policy, the government hoped that the Bank would explain more clearly its view on economic activity and prices and its outlook, as well as the relationship between these and the overcoming of deflation, thereby making it easier for market participants and the public to form an economic outlook and stabilizing their expectations.

V. Votes

Members agreed that it was appropriate to maintain the current guideline for money market operations, which encouraged the uncollateralized overnight call rate to remain at effectively zero percent.

To reflect this view, the chairman formulated the following proposal and put it to the vote.

The Chairman's Policy Proposal on the Guideline for Money 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 encourage the uncollateralized overnight call rate to remain at effectively zero percent.

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

VI. Discussion on the *Outlook for Economic Activity and Prices*

Members discussed the draft of the *Outlook for Economic Activity and Prices* (consisting of "The Bank's View" and "The Background"), and put "The Bank's View" 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 April 28, 2006 and the whole report on May 1, 2006.

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

Votes against the proposal: None.

Attachment

April 28, 2006
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by unanimous 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.

OUTLOOK FOR ECONOMIC ACTIVITY AND PRICES (APRIL 2006): THE BANK'S VIEW[5]

I. Outlook for Economic Activity and Prices

Japan's economy continues to recover steadily. Exports and production continue to increase. Business fixed investment also continues to increase against the backdrop of high corporate profits. Household income continues to rise moderately, reflecting improvements in employment and wages, and private consumption is on an increasing trend. With steady increases continuing in domestic and external demand, economic activity in fiscal 2005 seems to have been stronger than the projection in the October 2005 *Outlook for Economic Activity and Prices*. Consequently, the conditions of persistent oversupply have been dispersed and the output gap seems now to have closed.[6]

From fiscal 2006 through fiscal 2007, Japan's economy is likely to experience a sustained period of expansion, with domestic and external demand and also the corporate and household sectors well in balance. Given that the current recovery of the economy has already lasted for over four years and is likely to mature, the growth rate is likely to slow gradually toward the potential growth rate. The forecast is around 2.5 percent for fiscal 2006 and around 2 percent for fiscal 2007.

The outlook rests on the following underlying assumptions and mechanisms. First, exports are likely to remain on the increase reflecting the continuing expansion of overseas economies. Second, corporate performance is likely to continue to be strong. Corporate profits increased for the fourth consecutive fiscal year since 2002, and in fiscal 2006, the ratio of firms' current profits to sales will remain at levels exceeding the peak marked during the bubble era of the late 1980s. With regard to resource utilization, the capacity utilization rate is rising and firms are more often experiencing constraints arising from insufficient labor. In this environment, the March *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicated that in many industries business fixed investment plans for fiscal 2006 are relatively strong for the time of year. The plans are likely to be revised upward in subsequent surveys. Firms, conscious of increasing global competition, have been generally cautious about increasing business fixed investment and have not built up large capital stocks. Over the next two years, however, the growth rate of business fixed investment is at some point expected to fall off, in view of the capital stock cycle, reflecting the long economic recovery. Third, the positive influence of the strength in the corporate sector on the household sector is likely to become more evident. Strong corporate performance is benefiting the household sector via increases in employment and wages as well as increases in dividends and rising stock prices. Against this backdrop, private consumption is expected to continue increasing steadily. Housing investment is likely to experience a moderate uptrend, partly supported by the view that interest rates will only rise from current levels, as land prices are starting to rise particularly in central Tokyo. Household spending will be the main driving force behind firm domestic private demand and firm household spending in turn will feed back to the corporate sector, with the likelihood of a virtuous circle being maintained. Fourth, the extremely accommodative financial conditions are likely to continue to support private demand. As financial institutions adopt more proactive lending postures and as the demand for credit in the private sector stops declining, the year-on-year rate of increase in the amount outstanding of lending by private banks is on the rise. Short-term real interest rates are falling. In particular, these financial conditions may also be contributing to increases in business fixed investment by small firms and housing investment.

Given this economic outlook, the environment for prices is likely to change gradually. First, a higher level of resource utilization is being observed. The March *Tankan* indicated that firms are perceiving the strongest capacity constraints in terms of capital

5. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 28, 2006.
6. In view of the re-basing of the GDP statistics and retroactive revisions to the GDP series at the end of 2005, the method of calculating potential output was revised. The new estimate for the annual rate of change in potential output, i.e., the potential growth rate, for Japan's economy is now in the 1.5–2 percent range, up from approximately 1 percent. The output gap, the difference between actual and potential output, is estimated to have closed. It should be noted that these estimates of the potential growth rate and output gap are not exact, but vary over time depending on changes in the economic structure and the pace of technological innovation, and they may therefore be revised retroactively as new data are released.

stock and employment in more than a decade. The output gap has closed, and actual output is likely to gradually exceed potential output. Second, although unit labor costs (labor costs per unit of output) continue to decline due to increases in productivity, the rate of decline has been on a narrowing trend as a result of wages starting to increase. Given the tighter supply and demand balance of labor in a relatively wide range of industries and the likely slowing rate of productivity increases as the economic recovery matures, unit labor costs are expected to stop declining and start increasing slightly in the future. Third, results of various surveys show that firms and households are gradually shifting up their inflation expectations for both the short term and the medium to long term.

Looking at various indices for inflation, the domestic corporate goods price index in fiscal 2005 exceeded the October projection, recording the largest increase on a year-on-year basis since early 1990, reflecting higher international commodity prices and the weaker yen in the second half of 2005. While the prices of crude oil and other commodities and foreign exchange rates will influence it significantly, the index is likely to continue increasing through fiscal 2007.

The consumer price index (CPI; excluding fresh food, on a nationwide basis) has generally moved in line with the October projection, with the year-on-year changes turning positive toward the end of 2005 followed by larger increases since the beginning of 2006. In recent years, the rate of increase in the CPI may have become less sensitive to changes in the output gap. As explained below, the views on the mechanisms underlying this development will have a bearing on the outlook for the inflation rate. Accordingly, there are uncertainties, but the year-on-year rate of increase in the CPI is likely to gradually rise to around the middle of the range between zero and 1 percent in fiscal 2006 and to slightly below 1 percent in fiscal 2007.[7]

II. Positive and Negative Deviations

The outlook described above is the most likely projection based on the underlying assumptions and mechanisms mentioned earlier. It should be noted that there exist the following upside and downside risks to the outlook in the coming months.

The first risk is the growth path of the global economy. The outlook assumes that the economies of Japan's major trading partners continue to expand at a pace close to their potential growth rates. Therefore, depending on developments in their economies, Japanese exports and production may move either upward or downward from their expected trajectory. One of the factors supporting the ongoing expansion of the global economy is the durability of stable financial conditions and generally subdued inflationary pressures due at least in part to the appropriate conduct of monetary policy by central banks. Any changes to the picture may adversely affect the global economy, accompanied by shifts in international capital flows and repricing in financial markets. Global economic developments may also be influenced by international commodity prices, including crude oil prices, which have remained at elevated levels reflecting, for example, the higher level of geopolitical risks.

In the United States, if higher resource utilization coupled with, for example, the impact of the past rises in crude oil prices leads to higher inflationary expectations, responses in financial markets may bring about a fall in the economic growth rate. In addition, given that past rises in housing prices have contributed to the growth of private consumption, any sharp adjustment in housing prices may lead to lower growth rates. Meanwhile, the Chinese economy continues to expand robustly. Although there is a risk of repercussions from the robust economic growth, there still is a possibility that this growth will accelerate during the projection period, depending on developments in fixed asset investment and private consumption.

The second risk is the possibility of inventory adjustments. Levels of inventory are still relatively low even though the economy is already in the fifth year of recovery. However, given the projected slowdown in the growth rate, there are factors that may trigger inventory adjustments during the projection period. For example, although the demand for IT-related goods is likely to continue increasing, lower-than-expected growth in demand may trigger inventory adjustments, given that the

7. This outlook for inflation is based on the 2000 base CPI. The base year for the CPI will be changed to 2005 in August 2006, and year-on-year figures back as far as January 2006 will be revised retroactively. The year-on-year rate of increase in the 2005 base CPI is likely to be slightly lower than that obtained using the current 2000 base CPI.

supply of these goods is increasing at a very fast pace, including in the high-value-added products sector where Japanese firms have a competitive edge. When the adjustments actually occur, however, the impact of inventory adjustments on economic activity may not be pronounced, reflecting, for example, the fact that Japanese firms have on the whole completed adjustments in excesses in employment and production capacity as well as the high level of corporate profits.

The third risk is a further acceleration of business fixed investment. The outlook assumes that the growth in investment will gradually slow as the economic recovery matures gradually. If firms accelerate investment, there may be a positive impact on overall growth for a while. On the other hand, such acceleration may lead to an excessive build-up of capital stock which may precipitate an economic slowdown.

Looking at corporate finances, current conditions point to an acceleration in investment. Firms are less encumbered by debt, and levels of return on assets are comparable to those recorded during the bubble era of the late 1980s. Real interest rates are extremely low as well. Developments in asset prices such as land and stocks are also contributing to increasing private demand. Meanwhile, if financial markets price in the changing state of the economy, it may contribute to preventing large swings in economic activity.

Turning to developments in the inflation rate, factors causing the rate to deviate either upward or downward from the projection warrant attention. The first factor is the impact of the emerging positive output gap (i.e., actual output exceeding potential output). The weaker sensitivity of the rate of increase in the CPI to changes in the output gap is a tendency observed not only in Japan but also worldwide. This reflects developments such as deregulation, advances in information and telecommunication technology, and the deepening of economic globalization. Additionally, in Japan unit labor costs were able to fall considerably as productivity increased against the backdrop of a relatively low rate of resource utilization. However, assuming that demand gradually exceeds supply following the closing of the output gap, the rate of increase in wages and prices may accelerate at some point accompanied by an upward shift in the expected rate of inflation. The second factor is the path of the prices of crude oil and other commodities. There are substantial uncertainties in this regard. The third factor is the impact of an increase in the potential growth rate. An increase in the potential growth rate gives rise to downward pressure on prices from the supply side, whereas it may give rise to upward pressure on prices from the demand side via improvement in expectations of future income. The potential growth rate of the Japanese economy seems to be on an uptrend recently, after experiencing various structural adjustments. Nevertheless, given that it is difficult to observe such changes in real time, there is also uncertainty in this regard.

III. Conduct of Monetary Policy

The Bank of Japan decided to terminate the quantitative easing policy at the Monetary Policy Meeting 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. The new target for the uncollateralized overnight call rate was set at effectively zero percent.

Under the new guideline for money market operations, the volume of short-term funds-supplying operations by the Bank is decreasing. Accordingly, the outstanding balance of current accounts at the Bank is declining gradually. So far, the short-term money market remains stable and there is gradually more activity being seen in the interbank market. The Bank will continue to closely monitor conditions in the short-term money market, in reducing the outstanding balance of current accounts toward a level in line with required reserves.

The objective of the monetary policy of the Bank is stipulated as contributing to the sound development of the national economy through the pursuit of price stability. To this end, the Bank is pursuing an appropriate course of monetary policy. In the new framework for the conduct of monetary policy released on March 9, 2006, the Bank announced that it would assess economic activity and prices from two perspectives, taking account of the "understanding of medium- to long-term price stability," and that, in the light of this assessment, it would outline its current view on monetary policy.

Looking at the outlook deemed most likely by the Bank for economic activity and prices two years into the future (the first perspective), Japan's economy is likely to continue expanding with balanced domestic and external demand. The year-on-year rate of increase in the CPI (excluding fresh food, on a nationwide basis) is expected to rise gradually through fiscal 2007 as the output gap becomes slowly positive, indicating excess demand, and downward pressures from declining unit labor costs weaken. In sum, Japan's economy is likely to achieve sustainable growth under price stability.

Turning to the risks that are most relevant to conducting monetary policy, looking over a longer time horizon and taking account of the cost incurred when risks materialize, however improbable they might be (the second perspective), it can be seen that the stimulus from monetary policy to economic activity and prices may be amplified against the backdrop of improving corporate profitability and a turnaround in price developments. In this situation, given that the output gap has closed, there is a risk in the medium to long term of larger economic swings, resulting in large fluctuations in the rate of inflation. Meanwhile, even if economic activity is less robust and the inflation rate lower than expected, the risk of the economy falling into a vicious circle of declining prices and deteriorating economic activity has become smaller, since the Japanese financial system has regained stability and the economy has now cast off excesses in production capacity, employment, and debt.

With regard to the future course of monetary policy, as a result of the assessment of economic activity and prices from the two perspectives described above, it seems probable that the accommodative financial conditions ensuing from very low interest rates will be maintained for some time following a period in which the uncollateralized overnight call rate is at effectively zero percent. Through and beyond this stage, the Bank will adjust the level of interest rates gradually in the light of developments in economic activity and prices.

Forecasts of the Majority of Policy Board Members and Actuals for Fiscal 2005[1,2,3,4]

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Forecasts made in October 2005	**+2.2 to +2.5 [+2.2]**	**+1.6 to +1.8 [+1.7]**	**0.0 to +0.1 [+0.1]**
Actual	**+3.2**	**+2.1**	**+0.1**

Forecasts of the Majority of Policy Board Members for Fiscal 2006 and Fiscal 2007[1,2,3,4]

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2006	**+2.1 to +3.0 [+2.4]**	**+1.4 to +1.8 [+1.5]**	**+0.6 to +0.6 [+0.6]**
Forecasts made in October 2005	**+1.6 to +2.2 [+1.8]**	**+0.5 to +0.8 [+0.6]**	**+0.4 to +0.6 [+0.5]**
Fiscal 2007	**+1.8 to +2.4 [+2.0]**	**+0.8 to +1.1 [+1.0]**	**+0.7 to +0.9 [+0.8]**

Notes: *1.* Brackets indicate the median of the forecasts.
2. Real GDP for fiscal 2005 is calculated on the assumption that real GDP in the first quarter of 2006 equals that in the fourth quarter of 2005.
3. Individual Policy Board members make the above forecasts with reference to market participants' view regarding the future course of the policy interest rate that is incorporated in market interest rates. Their forecasts made in October 2005 were based on the assumption that there would be no change in monetary policy.
4. Forecasts of the majority of Policy Board members are the figures to which the individual members attach the highest probability and they are shown as a range, with the highest and lowest figures excluded. It should be noted that the range does not indicate the forecast errors.

The forecasts of all Policy Board members are as follows.

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2006	**+2.1 to +3.0**	**+1.3 to +1.8**	**+0.5 to +0.7**
Forecasts made in October 2005	**+1.3 to +2.4**	**+0.4 to +1.0**	**+0.4 to +0.6**
Fiscal 2007	**+1.6 to +2.5**	**+0.7 to +1.3**	**+0.7 to +1.0**

Publications of the Monetary Policy Meeting on May 18 and 19, 2006

Minutes

Released on June 20, 2006

The Bank's View of Recent Economic and Financial Developments

Released on May 19, 2006

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

MINUTES OF THE MONETARY POLICY MEETING ON MAY 18 AND 19, 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, May 18, 2006, from 2:00 p.m. to 3:53 p.m., and on Friday, May 19, from 9:00 a.m. to 12:03 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. M. Amamiya, 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. K. Kamiyama, Senior Economist, Monetary Affairs Department
Mr. K. Masaki, 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 money market operations in accordance with the guideline decided at the previous meeting on April 28, 2006.[5] The uncollateralized overnight call rate was stable at effectively zero percent. The outstanding balance of current accounts at the Bank had been decreasing gradually, and was in the 14–15 trillion yen range recently.

B. Recent Developments in Financial Markets

In the money market, interest rates on term instruments rose partly reflecting heightening of market expectations that the Bank might raise the target for the uncollateralized overnight call rate at an unexpectedly early timing. Interest rates on Euroyen futures temporarily increased for all delivery months but decreased thereafter, and were recently at around the same level as at the time of the previous meeting.

Japanese stock prices declined, reflecting an appreciation of the yen against the U.S. dollar and a decline in U.S. stock prices. The Nikkei 225 Stock

1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on June 14 and 15, 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 May 19.
3. Mr. K. Sugimoto was present on May 18.
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 encourage the uncollateralized overnight call rate to remain at effectively zero percent.

Average was recently moving in the range of 16,000–16,500 yen.

Long-term interest rates temporarily rose to around 2 percent but declined thereafter. Recently they were moving at around 1.95 percent.

The yen appreciated against the U.S. dollar partly because selling of the dollar had predominated over buying reflecting market participants' interpretation of the G-7 statement. The yen was recently being traded in the range of 109–111 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 the pace of increase in prices was relatively fast due to high energy prices, inflation expectations had remained contained thus far in a situation where the Federal Reserve had carried out successive raises of the target for the federal funds rate.

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

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 the United States, long-term interest rates rose and stock prices fell in a situation where energy prices remained high and labor market conditions continued to be tight. In Europe, long-term interest rates increased somewhat and stock prices weakened reflecting developments in U.S. financial markets. In emerging economies, stock prices and currencies fell.

D. Economic and Financial Developments in Japan

1. Economic developments

Exports had continued to increase against the background of the expansion of overseas economies, and were expected to continue to rise, as overseas economies expanded further, particularly in the United States and East Asia.

As for domestic private demand, 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.

Private consumption had been on an increasing trend. The number of new passenger-car registrations excluding small cars with engine sizes of 660 cc or less had been somewhat weak. However, the number of new passenger-car registrations including small cars had been picking up slightly so far this year, partly supported by the introduction of new models. Private consumption was likely to continue to increase steadily, mainly reflecting a gradual increase in household income.

Industrial production had continued to increase against the background of the growth in domestic and external demand. Production was expected to continue its uptrend, as overseas economies would continue to expand and domestic demand would continue to be solid. According to anecdotal information, production for the April–June quarter was likely to continue to increase.

As for the employment and income situation, 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.

Since the economic recovery had continued for more than four years, the conditions of persistent excess supply had been dispersed, and the output gap was currently close to zero and likely to gradually become positive.

On the price front, 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) had been on a positive trend, and this trend was projected to continue, as the output gap was likely to gradually become positive.

2. Financial environment

The environment for corporate finance was accommodative. The issuing environment for CP and corporate bonds was favorable, and the lending attitude of private banks had continued to be accommodative. The decline in credit demand in the private sector had come to a halt. Under these circumstances, the year-on-year rate of increase in the amount outstanding of lending by private banks for April increased significantly from that for March. According to statistics on loans and discounts outstanding by sector at the end of March, the year-on-year rate of decline in loans to large firms had diminished and the year-on-year rate of change in loans to small and medium-sized firms had turned positive. Meanwhile, the year-on-year growth rate 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, with domestic and external demand and also the corporate and household sectors well in balance, and that the conditions of persistent excess supply had been dispersed and the output gap was currently close to zero.

As for the outlook, members agreed that the economy was likely to continue to grow, slightly exceeding its potential growth rate, in an environment in which a virtuous cycle of production, income, and expenditure would operate. On this basis, members concurred that it would be appropriate to express the overall assessment of the economic outlook as "Japan's economy was expected to expand moderately" in the May issue of the *Monthly Report of Recent Economic and Financial Developments*. Some members expressed the view that the change from "recovery" to "expansion" reflected the Bank's assessment that the output gap was likely to become positive as the level of economic activity increased, as fully explained in the April *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), and did not necessarily imply faster economic growth. These members continued that, by adding the word "moderately" to "expand," the Bank could make clear that it expected economic growth to exceed the potential growth rate only slightly for some time.

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, although there were signs of deceleration, for example in housing sales, 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. One member said that the effects of a deceleration of housing investment on the U.S. economy were uncertain to some extent and they would require close monitoring. Regarding price developments, some members expressed the view that, given tight labor market conditions and the high capacity utilization rate, attention should be paid to the risk of a heightening of inflationary pressure reflecting the rise in commodity prices including crude oil prices. A few members commented that, as inflation risk had already started to become evident, the Federal Reserve's conduct of monetary policy had entered a more important phase.

With regard to East Asian economies, members agreed that both domestic and external demand continued to expand strongly in China. Some members referred to the People's Bank of China's decision to raise the benchmark lending rates of financial institutions, as well as to strengthen its "window guidance" to control credit expansion, and commented that attention should be paid to the effects of such policy actions on, for example, fixed asset investment.

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 the strength in the corporate sector was benefiting the household sector.

With regard to developments in the corporate sector, members agreed that business fixed investment was likely to keep increasing given that the perception among firms of having excess production capacity had dissipated and corporate profits remained high. A few members said that, although both shipments of capital goods and machinery orders, a coincident and a leading indicator of business fixed investment, respectively, were somewhat weak in the January–March quarter, business fixed investment seemed to be on an increasing trend given that investment plans were strong against the background of high corporate profits. One member pointed out that firms' stance on business fixed investment might not become as active as expected since some firms projected that their earnings for fiscal 2006 would decrease. A different member said that, in a situation where the extremely accommodative financial environment continued, business fixed investment by small nonmanufacturers, which were sensitive to interest rates, warranted attention. Some members said that the upward revision of business fixed investment plans for fiscal 2006 in the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan) was expected to be small compared to that in fiscal 2005, and attention should be paid to the extent of the actual revision.

Members concurred that private consumption had been on an increasing trend, and was likely to continue to recover steadily, mainly reflecting a gradual increase in household income. One member referred to the fact that some indicators of private consumption were somewhat sluggish in the January–March quarter, and said that this might be partly attributable to the plunge in prices of stocks listed on emerging stock exchanges, which had been gaining popularity among individual investors. Therefore, the effects of asset price developments on private consumption required close monitoring. A few members noted that consumer confidence was favorable, and expressed the view that the sluggishness of indicators of private consumption in the January–March quarter seemed to be a reaction to relatively strong rises in the previous quarter. One member commented that the figures in the *Family Income and Expenditure Survey* might be weaker than the actual developments due to a possible sample bias and should not be accepted at face value.

Members agreed that production had continued to increase and was likely to increase further against the background of the growth in domestic and external demand. Members also concurred that inventories had been more or less in balance with shipments in the industrial sector as a whole. A few members referred to the fact that the year-on-year growth rate of inventories of electronic parts and devices had been gathering speed, and commented that there was a risk of unintended accumulation of inventories in the near future given the sector's aggressive stance on production. These members, however, added that such accumulation had not so far occurred.

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 were more aware of the shortage of labor. Some members said that various surveys indicated that the rate of increase in wages was slightly greater in spring 2006 than in 2005, and thus the positive influence of the strength in the corporate sector on the household sector was becoming more evident.

Members referred to the first preliminary estimate of GDP for the January–March quarter and agreed that developments in real GDP were firm, mainly led by private demand. One member noted that the year-on-year rate of decline in the GDP deflator was on a diminishing trend, partly reflecting the fact that the year-on-year decline in the deflator for domestic private demand had almost come to a halt, and therefore it was important to note when the deflator for private consumption turned positive.

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.

Members agreed that the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) was likely to continue to follow a positive trend, as the output gap gradually became positive reflecting the steady economic recovery and as downward pressure from unit labor costs weakened due to the rise in wages. In relation to this, some members raised the following points. First, the year-on-year change in the CPI, excluding special factors such as petroleum product prices and electricity and telephone charges, had continued to be positive. Second, given the current level of crude oil prices, petroleum product prices were likely to continue to place upward pressure on the year-on-year change in the CPI for some time. And third, the year-on-year change in the CPI for the Tokyo metropolitan area increased for April, particularly in services prices. A few members said that the effects of the revision of services prices at the turn of the fiscal year should be closely monitored.

B. Financial Developments

On the financial front, members concurred that the financial environment remained extremely accommodative. With regard to developments in corporate finance, members agreed that the year-on-year rate of increase in the amount outstanding of lending by private banks was accelerating, and that the decline in firms' credit demand had come to a halt.

Members discussed financial markets at home and abroad, which had been showing some nervousness recently.

With regard to foreign exchange markets, many members said that the U.S. dollar continued to depreciate due partly to market speculation about a possible adjustment of global imbalances and a change in the outlook for interest rate differentials between the U.S. and other economies, and thus developments in foreign exchange markets would warrant attention for some time. Some members expressed the view that the depreciation of the U.S. dollar against the yen was unlikely to seriously affect corporate profits for the time being, considering the exchange rate assumed by firms. They added that the effect of such developments in foreign exchange rates on foreign and domestic economic activity as well as prices required close monitoring.

Members pointed to the weak movements in stock prices at home and abroad, and agreed that they required careful monitoring in terms of not only their effects on economic activity but also the stability of international financial markets. A few members commented on the decline in prices of Japanese stocks that individual investors were losing their appetite for them due to uncertainty regarding firms' accounting in addition to the fall in stock prices overseas and concern that it might cause a decrease in inflow of foreign capital. One member commented that, although there seemed to be no change in market participants' perception that the fundamental environment surrounding Japanese stock prices was favorable, stock prices seemed to be undergoing slight adjustments following the rapid increase since the second half of 2005. A different member expressed the view that stock price adjustments were likely to be relatively small because stock markets in industrial countries had not been excessively bullish judging, for example, from negative yield spreads (government bond yields minus earnings-price ratios of stocks). Some members commented that there had been a massive inflow of funds even into smaller markets, for example, stock markets in emerging economies and commodity markets. A swing back was beginning to be observed in such markets, and the impact, if it gained momentum, should not be underestimated.

Some members commented on the factors behind the rise in U.S. long-term interest rates that concerns about inflation remained strong in a situation where the policy interest rate was approaching what seemed to be a neutral level, and against this background there was uncertainty about future developments in economic activity and prices.

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

On the monetary policy stance for the immediate future, members agreed that, based on their assessment of the economic and financial situation, it was appropriate to maintain the current guideline for money market operations that the Bank would encourage the uncollateralized overnight call rate to remain at effectively zero percent.

Members noted that the outstanding balance of current accounts at the Bank had been reduced without difficulty so far, and agreed that the Bank would continue to closely monitor conditions in the money market in reducing the outstanding balance. Many members said that the pace of reduction would depend on conditions in the money market and financial institutions' funds management in the immediate future, and if the money market continued to be stable, it was likely that the process of reduction of the current account balance would be almost complete within the period of a few months projected when the quantitative easing policy was terminated, in other words, within a few weeks. A few members said that developments in short-term interest rates might become unstable as the current account balance declined closer to the level of required reserves, and thus the Bank should continue to exercise due care in conducting money market operations. A few other members commented that transactions in the money market were on an increasing trend in a situation where the reduction of the current account balance had been progressing, and were expected to continue to recover.

Some members said that speculation that the Bank might raise the target for the uncollateralized overnight call rate at an unexpectedly early timing had increased temporarily in financial markets. They noted that market participants had become accustomed to an unusually explicit guideline for monetary policy, that based on the commitment on the CPI under the quantitative easing policy, and thus they were inclined to expect the Bank to provide a more specific criterion, and some were trying to predict the timing of a raise in the uncollateralized overnight call rate from, for example, the pace of reduction of the current account balance. A few members said that the Bank should explain again that the reduction of the current account balance and the raising of the target for the uncollateralized overnight call rate were two different issues.

Members discussed the future conduct of monetary policy and the Bank's communication of its thinking.

Members agreed that more market participants were coming to understand the Bank's thinking regarding the future course of monetary policy described in the April Outlook Report, which was as follows. First, it seemed probable that the accommodative financial conditions ensuing from very low interest rates would be maintained for some time following a period in which the uncollateralized overnight call rate was at effectively zero percent. And second, through and beyond this stage, the Bank would adjust the level of interest rates gradually in the light of developments in economic activity and prices. They agreed again on the following points. First, the future course of monetary policy described in the Outlook Report indicated the Bank's thinking regarding the pace of interest rate adjustments required to achieve sustained economic growth under price stability without large fluctuations over a time horizon of about two years ahead. And second, the timing of a change in monetary policy depended on future developments in economic activity and prices, and the Bank did not have a predetermined view regarding the future path of monetary policy.

In relation to this point, members agreed that, in considering the future conduct of monetary policy, it was important to examine, based on various economic indicators and information, whether the economy would follow the path projected in the April Outlook Report. Some members pointed out that developments since the turn of fiscal 2006 in, for example, prices, wages and employment, and business fixed investment would be important factors in making that judgment. Members agreed again that it was important that the Bank examine economic activity and prices as a whole from the two perspectives and explain its assessment carefully, so that no specific indicator would attract excessive attention as the CPI had under the quantitative easing policy.

Some members commented that the Bank should pay attention to market participants' views of the future path of the policy interest rate as well as changes in their views. One of these members noted that, although it was important to take into consideration market participants' views, the Bank should not automatically respond.

One member said that the difference between the trend of real GDP growth rate and real short-term interest rates had expanded considerably, and thus the Bank should conduct monetary policy appropriately so as not to be too late, paying attention to the risk of monetary policy becoming too stimulative, given that economic activity and prices were expected to follow the path projected in the April Outlook Report. A different member commented that the Bank should conduct monetary policy giving consideration to the fact that the recent decline in stock prices at home and abroad and large fluctuations in international commodity prices were causing anxiety among market participants. Another member expressed the view that, although the effects of expected economic obsolescence of capital stock were weakening gradually, the current situation was still at a stage where the marginal rate of return on investment had only recently started to rise moderately from an extremely low level. This member continued that, although the Bank should not maintain the zero interest rate environment for too long, the pace of rises in interest rates consistent with maintaining price stability would be moderate, unless the inflation rate accelerated markedly.

IV. Remarks by Government Representatives

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

(1) Japan's economy was recovering. However, given the large fluctuations in foreign exchange markets and the rise in interest rates and crude oil prices observed recently, their effects on domestic and overseas economies required careful attention. A comprehensive review of developments in prices suggested that the price situation was improving gradually, although the economy had not yet overcome deflation. The government considered that it was necessary to ensure that this improvement continued.

(2) The government, together with the Bank, should continue policy efforts to ensure the sustainability of the economic recovery and the overcoming of deflation to prevent the economy

from weakening again. The government would like the Bank to firmly support the economy from the financial side by maintaining a zero interest rate environment.

(3) The government would like the Bank to conduct monetary policy in such a way as would ensure market stability. Specifically, the Bank needed to be more careful in lowering the outstanding balance of current accounts at the Bank, because market participants were beginning to feel that liquidity was less abundant with the progress in the reduction of the current account balance. The government would also like the Bank to closely monitor developments in overall interest rates including long-term interest rates. Furthermore, in order to prevent financial markets from becoming unstable due to speculation regarding future monetary policy, the government would like the Bank to clearly explain its view on economic activity and prices as well as its thinking regarding the future course of monetary policy to market participants and the public.

The representative from the Cabinet Office made the following remarks.

(1) Japan's economy was recovering. According to the first preliminary estimate of GDP for the January–March quarter released on May 19, the real GDP growth rate was 0.5 percent on a quarter-on-quarter basis, and 1.9 percent on an annualized quarter-on-quarter basis. The nominal GDP growth rate for the same quarter was 0.0 percent on a quarter-on-quarter basis, and 0.2 percent on an annualized quarter-on-quarter basis. Although the price situation had been showing some improvement, a comprehensive review of developments in prices suggested that moderate deflation persisted as evidenced by, for example, the GDP deflator, which continued to exhibit a year-on-year decrease. 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 Bank had been maintaining an accommodative financial environment by encouraging the uncollateralized overnight call rate to remain at effectively zero percent, taking consistency with the government's basic policy for the economy fully into consideration. The government would like to request that the Bank, in its future conduct of monetary policy, continue its policy efforts to overcome deflation together with the government and support the economy from the financial side responsibly, giving due consideration to downside risk to economic activity and prices as well as developments in financial markets. To prevent the financial markets from becoming unstable due to speculation regarding the future conduct of monetary policy, the government hoped that the Bank would explain more clearly its view on economic activity and prices and its outlook, thereby making it easier for market participants and the public to form an economic outlook and stabilizing their expectations.

V. Votes

Based on the above discussions, members agreed that it was appropriate to maintain the current guideline for money market operations, which encouraged the uncollateralized overnight call rate to remain at effectively zero percent.

To reflect this view, <u>the chairman</u> formulated the following proposal and put it to the vote.

The Chairman's Policy Proposal on the Guideline for Money 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 encourage the uncollateralized overnight call rate to remain at effectively zero percent.

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

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 May 19, 2006 and the whole report on May 22, 2006.[6]

VII. Approval of the Minutes of the Monetary Policy Meeting

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of April 10 and 11, 2006 for release on May 24, 2006.

Attachment

May 19, 2006
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by unanimous 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.

6. The English version of the whole report was published on May 23, 2006.

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 on an increasing trend. Housing investment has shown some strength. Meanwhile, public investment has been on a downtrend.

Japan's economy is expected to expand moderately.

The conditions of persistent excess supply have been dispersed, and the output gap now seems to be close to zero. Furthermore, in the period ahead, 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. 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 change in consumer prices (excluding fresh food) has been on a positive trend.

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 continue to follow a positive trend, as the output gap is likely to gradually become positive.

As for the financial environment, the environment for corporate finance is accommodative. The issuing environment for CP and corporate bonds is favorable. Also, the lending attitude of private banks has continued to be accommodative. The decline in credit demand in the private sector has come 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. Funding costs for firms have risen slightly. Meanwhile, the year-on-year growth rate of the money stock has been at the 1.0–2.0 percent level. As for developments in financial markets, in the money markets, the overnight call rate has been effectively zero percent under the Bank of Japan's guideline for money market operations. Interest rates on term instruments have risen compared with last month. In the foreign exchange and capital markets, the yen's exchange rate against the U.S. dollar has risen compared with last month, while stock prices have fallen compared with last month. Meanwhile, long-term interest rates have been around the same level as last month.

7. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on May 18 and 19, 2006. It is based on information available at the time of the meeting.

Publications of the Monetary Policy Meeting on June 14 and 15, 2006

Minutes

Released on July 20, 2006

The Bank's View of Recent Economic and Financial Developments

Released on June 15, 2006

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

MINUTES OF THE MONETARY POLICY MEETING ON JUNE 14 AND 15, 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, June 14, 2006, from 2:00 p.m. to 4:01 p.m., and on Thursday, June 15, from 9:00 a.m. to 12:06 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. M. Shirakawa, Executive Director
Mr. A. Yamamoto, Executive Director
Mr. A. Horii, Executive Director (Assistant Governor)[4]
Mr. M. Amamiya, 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

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. S. Yamaguchi, 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 money market operations in accordance with the guideline decided at the previous meeting on May 18 and 19, 2006.[6] The uncollateralized overnight call rate was at effectively zero percent, although it temporarily edged somewhat higher in late May and the middle of June. The outstanding balance of current accounts at the Bank had been decreasing gradually, and was at around 10 trillion yen recently.

B. Recent Developments in Financial Markets

In the money market, interest rates on term instruments rose. Interest rates on Euroyen futures fell, particularly in distant contract months.

Japanese stock prices declined from the previous month. The Nikkei 225 Stock Average was recently moving in the range of 14,000–14,500 yen.

Long-term interest rates decreased, mainly reflecting the decline in Japanese stock prices. Recently they were moving at around 1.8 percent.

1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on July 13 and 14, 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 June 15.
3. Mr. K. Sugimoto was present on June 14.
4. Mr. A. Horii concurrently held the post of Director-General of the International Department.
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 encourage the uncollateralized overnight call rate to remain at effectively zero percent.

The yen depreciated against the U.S. dollar due mainly to market participants' speculation regarding U.S. monetary policy. The yen was being traded at around 114 yen to the dollar recently.

C. Overseas Economic and Financial Developments

The U.S. economy continued to expand at a pace around its potential growth rate, but the rate of growth was moderating recently. Although the pace of increase in the consumer price index (CPI) for all items was relatively fast due to high energy prices, the increase in the core inflation rate (the CPI for all items less food and energy) was moderate.

In the euro area, the momentum for economic recovery increased gradually as exports and production were increasing and household spending was emerging from its weak situation.

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 fluctuated widely and stock prices were weak on the whole, partly reflecting speculation about the Federal Reserve's monetary policy for the near future. In many emerging economies also, stock prices continued to be weak.

D. Economic and Financial Developments in Japan

1. Economic developments

Exports had continued to increase against the background of the expansion of overseas economies, and were expected to continue to rise as overseas economies expanded further, particularly those of the United States and East Asia.

As for domestic private demand, 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.

Sales indicators related to private consumption had been sluggish recently. This seemed to be partly attributable to adverse weather conditions. On a GDP basis, real private consumption continued its steady increase.

Industrial production had continued to increase against the background of the growth in domestic and external demand. Production was expected to continue its uptrend, as overseas economies would continue to grow and the recovery in domestic demand would continue to be solid.

As for the employment and income situation, household income had continued rising moderately, reflecting improvements in employment and wages, in a situation where various indicators for labor market conditions had been improving. The gradual increase in household income was likely to continue.

Since the economic recovery had continued for more than four years, the conditions of persistent excess supply had been dispersed, and the output gap was currently close to zero and likely to gradually become positive.

On the price front, domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices, and were expected to continue increasing. The year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) had been on a positive trend, and this trend was projected to continue, as the output gap was likely to gradually become positive.

2. Financial environment

The environment for corporate finance was accommodative. The issuing environment for CP and corporate bonds was favorable, and the lending attitude of private banks had continued to be accommodative. The decline in credit demand in the private sector had come 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. Funding costs for firms had risen slightly. Meanwhile, the year-on-year growth rate 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 had generally followed the Bank's projection presented in the April *Outlook for Economic Activity and Prices* (hereafter the Outlook Report). They concurred that Japan's economy continued to recover steadily, with domestic and external demand and also the corporate and household sectors well in balance, and said that it was expected to expand moderately.

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 noted that, although it continued to expand at a pace around its potential growth rate, housing construction was cooling and some indicators for household spending and employment also suggested a slowdown in the pace of economic expansion. One member said that, despite the deceleration in housing investment and other indicators, the U.S. economy had been firm due to strong business investment in equipment and construction. Regarding price developments, many members expressed the view that the public had become more aware of inflation risk due to tight labor market conditions and high capacity utilization, coupled with the rise in prices of commodities including oil. These members said that whether the economic deceleration in the United States would result in a soft landing, thereby containing concerns about inflation, was a focus of attention.

With regard to East Asian economies, members agreed that both domestic and external demand continued to expand strongly in China. One member commented that a key factor for developments in the Chinese economy was whether the recently started tightening of monetary policy could absorb excessive liquidity, thereby containing upside risks of investment activities and consumption.

On European economies, one member expressed the view that the momentum for a recovery had been increasing gradually, partly offsetting the adverse effect of the deceleration in the U.S. economy.

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

As for domestic private demand, members concurred that the strength in the corporate sector continued and this was benefiting the household sector.

With regard to developments in the corporate sector, members agreed that business fixed investment was likely to keep increasing, given that the perception among firms of having excess production capacity had dissipated and corporate profits remained high. Some members said that business fixed investment surged in the January–March quarter, according to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, and investment plans for fiscal 2006 were relatively strong in surveys. They continued that they would check the strength in business fixed investment in the June *Tankan* (Short-Term Economic Survey of Enterprises in Japan). Some members said that the pace of increase in profits for small and medium-sized firms was decelerating recently due partly to the rise in the cost of materials, and they would therefore pay attention to the effects of this slower increase in profits on developments in business fixed investment.

Members concurred that private consumption, which had been on an increasing trend, was likely to continue to recover steadily, mainly reflecting a gradual increase in household income. One member said that the recent sluggishness in sales indicators might have been caused by the fall in stock prices in addition to adverse weather conditions.

Members agreed that production had continued to increase and was likely to increase further against the background of the growth in domestic and external demand. Members also concurred that inventories had been more or less in balance with shipments in the industrial sector as a whole. Some members said that, although the pace of increase in inventories of electronic parts and devices had decelerated somewhat, they would watch for a possible adjustment in inventories partly because demand related to the World Cup had been weaker than expected.

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 were more aware of the shortage of labor. Some members said that, besides firms' stance of restraining labor costs, the reason for regular payments being somewhat weak recently was the continuing effects of changes, which had been made in January, in samples used in the *Monthly Labour Survey*, and that wages had been rising gradually as a trend.

With regard to prices, members agreed that domestic corporate goods prices, which had been increasing due mainly to the rise in international commodity prices, were likely to continue to increase.

Members agreed that the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) was likely to continue to follow a positive trend, as the output gap gradually became positive reflecting the steady economic recovery and as downward pressure from unit labor costs weakened due to the rise in wages. A few members pointed out that revisions of some services prices at the turn of the fiscal year had affected recent price developments, and said that the uptrend of the CPI was becoming firmly established as it was being caused by the rise in prices of a wide range of goods and services, rather than only certain items.

As for land prices, one member noted that the year-on-year rate of change in the urban land price index (average for all types of land) in the six large city areas registered a 3.8 percent rise, the first positive figure in 15 years. The member expressed the view that, although land prices were currently consistent with the expected return, careful monitoring would be required to check how the accommodative monetary policy affected them.

B. Financial Developments

On the financial front, members concurred that the financial environment in terms of corporate finance, such as the lending attitude of private banks and the issuing environment for CP and corporate bonds, remained extremely accommodative, although there were large swings in financial markets at home and abroad.

Many members said that the decline in stock prices was being widely observed in major industrial countries and emerging economies, albeit to differing degrees, and described the decline as basically an adjustment following the considerable increase since the second half of 2005. A few members added that prices of some international commodities, such as nonferrous metals, showed similar developments. Many members said that investors had been losing their risk appetite in a situation where monetary policy had entered a different phase worldwide. Many members commented that concerns about inflation and a slowdown in the U.S. economy had recently been highlighted and this was affecting current movements in stock prices. However, some of these members expressed the view that the decline in stock prices should not necessarily be taken as an indication of some sort of a change in the global economy, since there had not been any essential change in economic fundamentals worldwide or in Japan thus far. With regard to the effects of developments in stock prices on the future path of the economy, some members expressed the view that, if stock prices faced a long or a large adjustment, it could negatively affect the economy through, for example, changes in public sentiment. As a result of these discussions, members concurred that they would carefully monitor developments in international financial markets, including their impact on the economy.

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

On the monetary policy stance for the immediate future, members agreed that, based on their assessment of the economic and financial situation, it was appropriate to maintain the current guideline for money market operations that the Bank would encourage the uncollateralized overnight call rate to remain at effectively zero percent.

Members concurred that, as long as developments in economic activity and prices followed the Bank's projection presented in the April Outlook Report, it would be appropriate to conduct monetary policy in line with the thinking described in it. On this basis, most members said that, although developments in economic activity and prices had so far been generally in line with the projection presented in the Outlook Report, the Bank should continue to assess the economic and financial environment, including developments in financial markets worldwide and the U.S. economy. One of these members added that, as economic activity and prices were not facing an imminent upside risk, there was still time for the Bank to carefully assess the economic and financial environment. One member commented that it would be appropriate for the Bank to decide to maintain the current guideline for money market operations at this meeting, since the Bank needed to monitor whether interest rates in the money market were being formed in a stable manner and should conduct monetary policy carefully in order not to surprise market participants. This member added, however, that in terms of the current economic fundamentals the foundation for raising interest rates had already been laid. Another member said that the Bank should take policy action at an appropriate time, given that the difference between the trend of real GDP growth rate and real short-term interest rates had been expanding further and monetary policy had become more stimulative.

Members agreed that, despite small temporary increases in short-term interest rates, taken as a whole, developments in the money market had been generally stable in the process of reducing the outstanding balance of current accounts at the Bank and it had been reduced without difficulty. Many members said that, as a result of the reduction of the balance, the proper functioning of the call market had been steadily restored, as seen in the fact that interest rates had shown some fluctuations reflecting market conditions and the volume of market transactions had been gradually increasing. They said that in this situation it was no longer difficult for the Bank to control the uncollateralized overnight call rate through money market operations, and in this sense the reduction of the current account balance had virtually been completed. In relation to this, one member commented that the Bank should, in some way, inform the market that the reduction of the current account balance had virtually been completed. Many members said that the Bank should continue to adjust the current account balance through money market operations, responding to changes in various factors such as the supply-demand balance of funds in the market and liquidity positions of individual financial institutions. They said that the Bank should explain to market participants that, under the current scheme of controlling the uncollateralized overnight call rate, such an adjustment of the current account balance did not reflect any policy intention.

A few members said that, although the proper functioning of the money market had been gradually restored, the Bank should encourage market participants to increase their preparedness for a change in the market environment because there was still room for improvement, for example, in setting of credit lines to secure liquidity.

Members discussed what level the loan rate for the complementary lending facility should be. Many members noted that, while a narrow spread between the overnight call rate target and the complementary lending facility's loan rate might hinder restoration of the proper functioning of the money market, it would have the positive effect of stabilizing market interest rates in a situation where the functioning of the money market was not sufficiently restored. In this situation, members agreed that the Bank should endeavor to find the appropriate degree of spread between the target and the loan rate.

IV. Remarks by Government Representatives

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

(1) Japan's economy was recovering, as seen in the recently released second preliminary estimate of GDP for the January–March quarter, which indicated that the real GDP growth rate was 0.8 percent on a quarter-on-quarter basis. However, the effects of developments in oil prices on domestic and overseas economies required careful monitoring, as they remained at high levels. A comprehensive review of developments in prices suggested that the price situation was improving gradually, although the economy had not yet overcome deflation. The government considered that it was necessary to ensure that this improvement continued. The government would like the Bank, together with the government, to continue policy efforts to ensure the sustainability of the economic recovery and the overcoming of deflation to prevent the economy from weakening again.

(2) Financial markets had been experiencing some instability, for example, the recent plunge in stock prices. Therefore, the environment surrounding the financial markets would require careful monitoring.

(3) Regarding the monetary policy stance for the immediate future, the government would like the Bank to firmly support the economy from the financial side by maintaining a zero interest rate environment and give due consideration to developments in financial markets.

(4) Furthermore, in order to prevent financial markets from becoming unstable due to speculation regarding future monetary policy, the government would like the Bank to clearly explain its thinking regarding the future course of monetary policy to market participants and the public.

The representative from the Cabinet Office made the following remarks.

(1) Japan's economy was recovering. Although the continuous decline in prices, in other words deflation, persisted, the price situation had been showing some improvement. In order to accelerate and deepen structural reforms, the government would compile "Basic Policies for Economic and Fiscal Management and Structural Reform" for fiscal 2006, a Cabinet statement that aimed

to strengthen economic growth and competitiveness as well as improve the fiscal position.

(2) The Bank had been maintaining an accommodative financial environment by encouraging the uncollateralized overnight call rate to remain at effectively zero percent, taking consistency with the government's basic policy for the economy fully into consideration. The government would like to request that the Bank, in its conduct of monetary policy, continue its policy efforts alongside those of the government by supporting the economy from the financial side responsibly, giving due consideration to downside risk to economic activity and prices as well as developments in financial markets, so that the government's important policy goal of overcoming deflation in fiscal 2006 would be achieved. To prevent the financial markets from becoming unstable due to speculation regarding the future conduct of monetary policy, the government hoped that the Bank would explain more clearly its view on economic activity and prices and its outlook, thereby making it easier for market participants and the public to form an economic outlook and stabilizing their expectations.

V. Votes

Based on the above discussions, members agreed that it was appropriate to maintain the current guideline for money market operations, which encouraged the uncollateralized overnight call rate to remain at effectively zero percent.

To reflect this view, the chairman formulated the following proposal and put it to the vote.

The Chairman's Policy Proposal on the Guideline for Money 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 1).

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

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

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 June 15, 2006 and the whole report on June 16, 2006.[7]

VII. Approval of the Minutes of the Monetary Policy Meetings

The Policy Board approved unanimously the minutes of the Monetary Policy Meetings of April 28, 2006 and May 18 and 19 for release on June 20, 2006.

VIII. Approval of the Scheduled Dates of the Monetary Policy Meetings in July–December 2006

At the end of the meeting, the Policy Board approved the dates of the Monetary Policy Meetings to be held in the period July–December 2006, for immediate release (see Attachment 2).

7. The English version of the whole report was published on June 19, 2006.

Attachment 1

June 15, 2006
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by unanimous 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

June 15, 2006
Bank of Japan

Scheduled Dates of Monetary Policy Meetings in July–December 2006

	Date of MPM	Publication of Monthly Report (The Bank's View)	Publication of MPM Minutes
July 2006	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.)	Oct. 18 (Wed.)
Oct.	12 (Thur.), 13 (Fri.)	13 (Fri.)	Nov. 21 (Tue.)
	31 (Tue.)	—	Dec. 22 (Fri.)
Nov.	15 (Wed.), 16 (Thur.)	16 (Thur.)	Dec. 22 (Fri.)
Dec.	18 (Mon.), 19 (Tue.)	19 (Tue.)	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* (October 2006) will be published at 3:00 p.m. on Tuesday, October 31, 2006 (the whole report including the background will be published at 2:00 p.m. on Wednesday, November 1).

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

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 on an increasing trend. Housing investment has increased moderately. Meanwhile, public investment has been on a downtrend.

Japan's economy is expected to expand moderately.

The conditions of persistent excess supply have been dispersed, and the output gap now seems to be close to zero. Furthermore, in the period ahead, 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. 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 change in consumer prices (excluding fresh food) has been on a positive trend.

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 continue to follow a positive trend, as the output gap is likely to gradually become positive.

As for the financial environment, the environment for corporate finance is accommodative. The issuing environment for CP and corporate bonds is favorable. Also, the lending attitude of private banks has continued to be accommodative. The decline in credit demand in the private sector has come 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. Funding costs for firms have risen slightly. Meanwhile, the year-on-year growth rate of the money stock has been at the 1.0–2.0 percent level. As for developments in financial markets, in the money markets, the overnight call rate has been effectively zero percent under the Bank of Japan's guideline for money market operations. Interest rates on term instruments have risen compared with last month. In the foreign exchange and capital markets, the yen's exchange rate against the U.S. dollar, stock prices, and long-term interest rates have fallen compared with last month.

8. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on June 14 and 15, 2006. It is based on information available at the time of the meeting.

Money Market Operations in Fiscal 2005 (Summary)

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

Summary

For most of fiscal 2005, the Bank of Japan conducted money market operations with the target of maintaining the outstanding balance of current accounts at the Bank at around 30–35 trillion yen decided at the Monetary Policy Meeting (MPM) on January 19 and 20, 2004 (Chart). This target level significantly exceeded the required reserves, approximately 6 trillion yen, to be held by financial institutions at the Bank under the reserve requirement system and other requirements.[1] Meanwhile, it was decided at the MPM on May 19 and 20, 2005, against the backdrop of weaker bidding incentives by counterparties in the Bank's funds-supplying operations reflecting increased abundance of liquidity at financial institutions, to amend the proviso to add that there might be cases where the balance of current accounts fell short of the target 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.

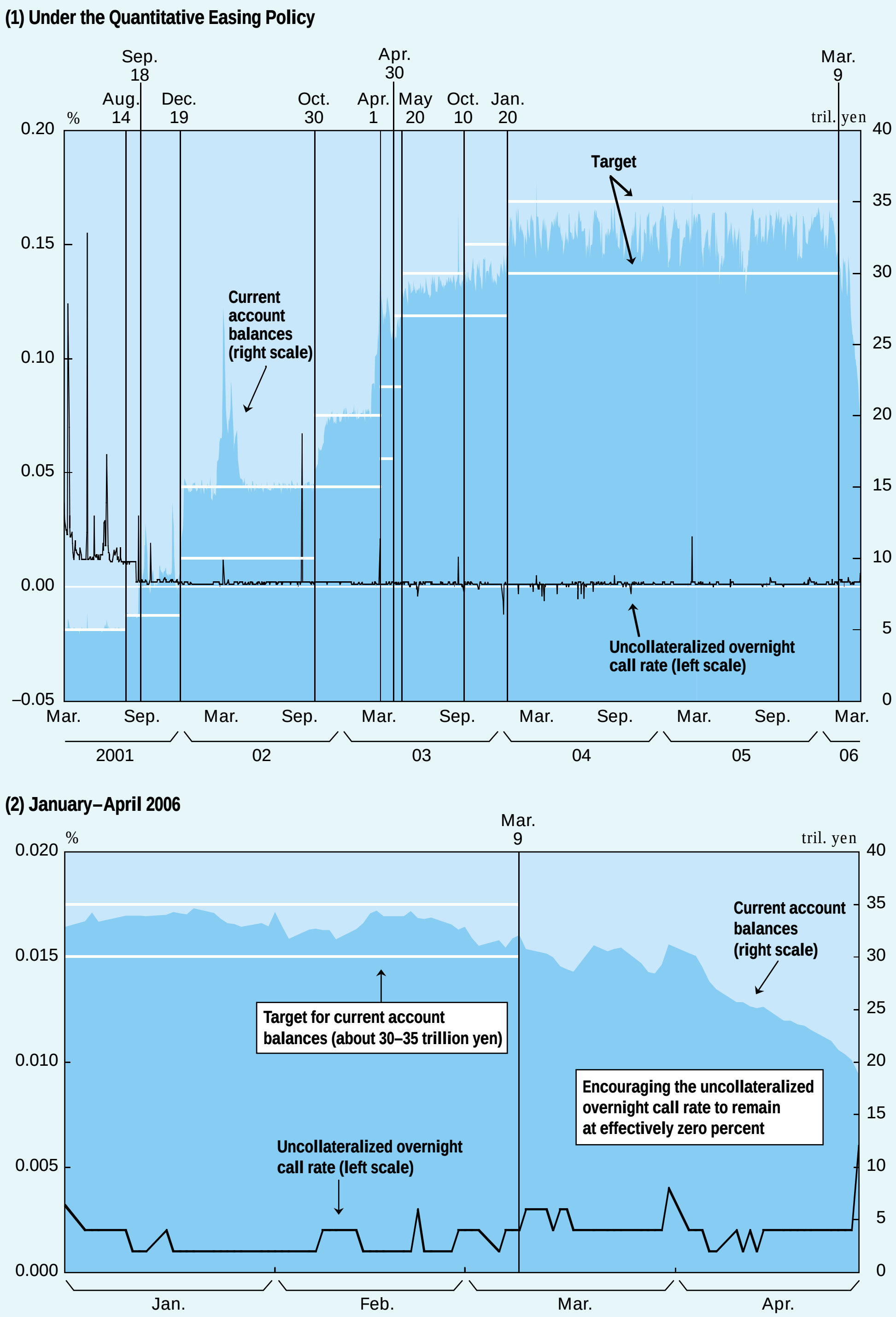
Under the guideline for money market operations described above, the Bank continued to provide ample liquidity in fiscal 2005. Since summer 2005, circumstances in the financial markets for money market operations have begun to change. Up to July 2005, liquidity demand among financial institutions declined further and frequent "undersubscription" (aggregate bids falling short of offers) was observed in the Bank's funds-supplying operations, as it became more evident that concerns about financial system stability abated further with the full removal of blanket deposit insurance in April 2005. In this situation, in early June, end-July, and early August, the outstanding balance of current accounts temporarily fell below 30 trillion yen for a total of six business days, as the amendment to the proviso made at the May 2005 MPM was applied. After August 2005, however, prospects of a rise in interest rates emerged reflecting heightened views that the monetary policy framework would be changed. Against this background, bidding by financial institutions to the funds-supplying operations gradually began to recover and the outstanding balance of current accounts was steadily maintained within the target range.

At the MPM 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 encourage the uncollateralized overnight call rate to remain at effectively zero percent. At the same time, the outstanding balance of current accounts at the Bank was to be reduced toward a level in line with required reserves over a period of a few months.

After this change, up to the end of fiscal 2005, the uncollateralized overnight call rate remained at an extremely low level, while the outstanding balance of current accounts was maintained at around 30 trillion yen. On the last business day of fiscal 2005, the uncollateralized overnight call rate was 0.004 percent, an extremely low rate for a fiscal year-end. Up to the end of April 2006, the uncollateralized overnight call rate remained at effectively zero percent, even after the outstanding balance began to be gradually reduced from the beginning of April.

1. Japan Post is not subject to the reserve requirement system, but the Bank has a contract with Japan Post in which Japan Post is to maintain a designated minimum amount of balances, in the form of current account balances, at the Bank. Relevant figures in this report include those on deposits of Japan Post.

Chart
Current Account Balances and the Uncollateralized Overnight Call Rate



Source: Bank of Japan.

Japan's International Investment Position at Year-End 2005 (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. Overview (Chart 1)

Japan's international investment position (IIP) (the outstanding amount of external financial assets of residents in Japan minus the outstanding amount of external financial liabilities of residents in Japan) recorded a net asset position of 180.7 trillion yen at year-end 2005. This represents a decrease of 5.1 trillion yen or 2.7 percent from the previous year-end, but marks the second highest level on record after the historical high set at year-end 2004.

The small decrease in the net asset position is largely due to the comparatively large increase in liabilities reflecting the substantial rise in Japanese stock prices, although assets also increased as a result of the current account surplus.

B. Developments in Assets and Liabilities by Component (Charts 2 and 3)

1. Direct investment (direct investment assets: 45.6 trillion yen; direct investment liabilities: 11.9 trillion yen)

Direct investment assets increased for the second consecutive year, rising by 7.0 trillion yen or 18.2 percent from year-end 2004. This was primarily due to (1) an increase in direct investments in North America and Asia by Japanese companies in order to expand existing business, and (2) an increase in the yen-denominated value of assets reflecting the depreciation of the yen against the U.S. dollar. Direct investment liabilities also increased by 1.8 trillion yen or 17.9 percent, reflecting direct investment mainly from the European Union (EU) and Asia.

2. Portfolio investment (assets: 249.5 trillion yen; liabilities: 182.0 trillion yen)

Portfolio investment assets increased by 40.2 trillion yen or 19.2 percent from year-end 2004. This substantial increase was due to (1) an increase in investment by investment trusts in equity securities of emerging economies and real estate investment trusts (REITs), (2) an increase in investment by banks in bonds and notes, (3) an increase in the value of assets reflecting the depreciation of the yen against the U.S. dollar, and (4) an increase in the value of equity securities reflecting the rise in French and German stock prices. Portfolio investment liabilities also increased, by 61.9 trillion yen or 51.5 percent. This sharp increase was primarily due to (1) the continued purchase of Japanese equity securities by nonresident investors supported by a favorable outlook for the business performance of Japanese companies, and (2) an increase in the value of equity securities reflecting the rise in Japanese stock prices.

3. Financial derivatives (assets: 3.1 trillion yen; liabilities: 3.9 trillion yen)

Both financial derivatives assets and liabilities increased from year-end 2004.

4. Other investment (assets: 108.5 trillion yen; liabilities: 127.7 trillion yen)

Other investment assets increased by 10.8 trillion yen or 11.1 percent from year-end 2004, primarily due to the outflow of yen funds for the purchase of equity securities. Other investment liabilities also increased, by 11.0 trillion yen or 9.4 percent, marking the sixth consecutive year of increase. The increase is attributable to a rise in borrowing from banks' overseas branches through their interoffice accounts.

5. Reserve assets (assets: 99.4 trillion yen)

Reserve assets rose for the seventh consecutive year, increasing by 11.7 trillion yen or 13.4 percent from year-end 2004. This was due to an increase in the value of assets reflecting the depreciation of the yen and an addition of interest accruing from bonds and notes to the reserve assets.

C. Factors Accounting for the Change in Net Assets (Charts 4 and 5)

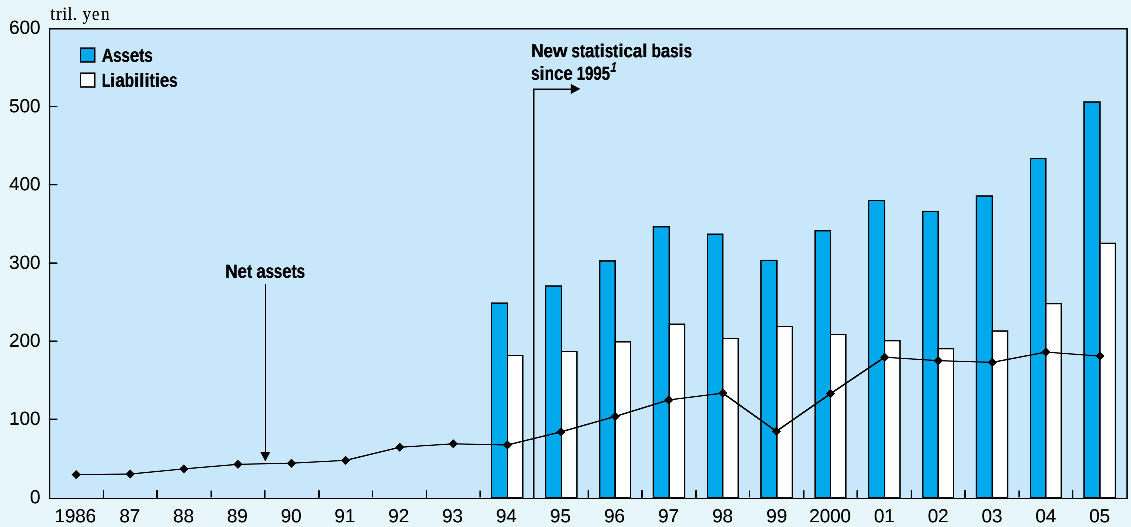
An analysis of the factors underlying the decrease in Japan's net asset position by 5.1 trillion yen in 2005 shows the following. The transaction factor accounted for a net increase of 15.0 trillion yen due to an expansion on the asset side reflecting the large current account surplus for 2005. The exchange rate change factor increased the yen-denominated value of net assets by 24.1 trillion yen, primarily because of the depreciation of the yen by 13.2 percent against the U.S. dollar compared to year-end 2004. Other factors accounted for a net decrease of 44.2 trillion yen due to the rise in Japanese stock prices, which resulted in a 43.1 trillion yen increase in liabilities.

D. International Comparison of Net Assets (Chart 6)

Japan has been the country with the largest net asset position for the 15th consecutive year since year-end 1991.

1. All figures in charts are as of the end of the year.

Chart 1
International Investment Position (IIP)



Note: 1. Figures from 1995 onward are calculated in accordance with the *Balance of Payments Manual* (Fifth Edition) issued by the International Monetary Fund (IMF). Figures prior to 1995 are compatible with the *Balance of Payments Manual* (Fourth Edition).

Chart 2
Contribution to Year-on-Year Changes by Component

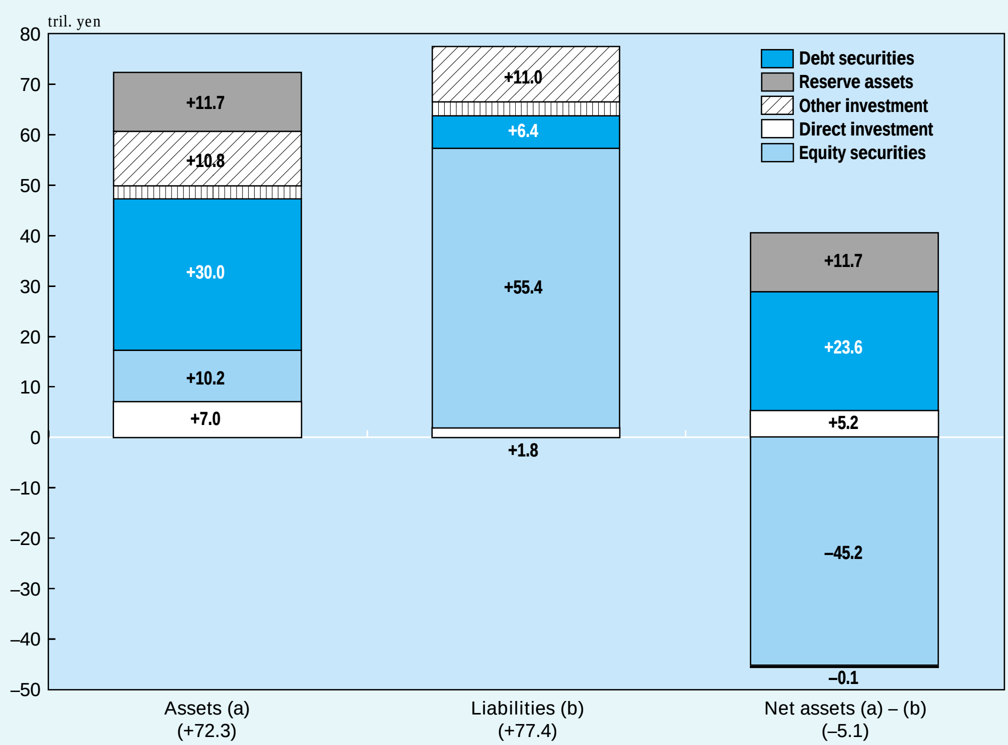


Chart 3

Assets and Liabilities by Component at End-2005

tril. yen

	Assets	y/y chg.	Liabilities	y/y chg.	Net assets	y/y chg.
Total	506.2	+72.3	325.5	+77.4	180.7	–5.1
Direct investment	45.6	+7.0	11.9	+1.8	33.7	+5.2
Portfolio investment	249.5	+40.2	182.0	+61.9	67.5	–21.6
Equity securities	48.2	+10.2	132.8	+55.4	–84.6	–45.2
Bonds and notes	198.3	+30.7	41.4	+7.6	156.9	+23.1
Money market instruments	3.0	–0.7	7.7	–1.2	–4.7	+0.5
Financial derivatives	3.1	+2.5	3.9	+2.8	–0.8	–0.3
Other investment	108.5	+10.8	127.7	+11.0	–19.2	–0.1
Of which: Loans	79.2	+7.0	94.8	+4.0	–15.6	+3.0
Reserve assets	99.4	+11.7	—	—	99.4	+11.7

Chart 4

Change in Net Asset Position by Factor

tril. yen

	Change from end-2004	Transaction factor	Exchange rate change factor	Other factors
Net asset position	–5.1	+15.0	+24.1	–44.2
Assets	+72.3	+41.7	+31.8	–1.1
Liabilities	+77.4	+26.7	+7.7	+43.1

Chart 5

Yen's Exchange Rates at Year-End

yen

	2002	03	04	05
Yen/U.S. dollar[1]	119.37	106.97	103.78	117.48
Yen/euro[2]	125.72	134.91	140.96	139.70

Notes: *1.* Mid-rates based on offer and bid rates quoted by interbank market participants in the Tokyo market; as of 5 p.m. JST.
2. Arbitrage rate.

Source: Bank of Japan, *Bank of Japan Statistics*.

Chart 6

Net Assets of Major Countries: An International Comparison[1,2,3,4]

tril. yen

	Year-end	Assets	Liabilities	Net assets	Ratio to nominal GDP (%)
Japan	**2005**	**506.2**	**325.5**	**180.7**	**35.9**
	2004	**433.9**	**248.1**	**185.8**	**36.8**
Switzerland	**2004**	**206.4**	**157.6**	**48.9**	**119.1**
Hong Kong	**2004**	**143.3**	**99.1**	**44.2**	**255.7**
China	**2005**	**143.7**	**109.8**	**33.9**	**12.7**
Germany	**2004**	**482.5**	**454.5**	**28.0**	**8.9**
France	**2004**	**455.5**	**439.8**	**15.7**	**6.7**
Belgium	**2004**	**156.2**	**144.5**	**11.7**	**28.7**
Russia	**2004**	**40.9**	**40.5**	**0.4**	**0.7**
Italy	**2004**	**188.3**	**201.2**	**−12.9**	**−6.7**
Canada	**2005**	**101.7**	**119.5**	**−17.8**	**−12.9**
United Kingdom	**2005**	**977.0**	**1,020.8**	**−43.8**	**−17.8**
Australia	**2005**	**56.0**	**104.4**	**−48.4**	**−60.4**
Spain	**2005**	**156.7**	**214.7**	**−58.0**	**−46.2**
United States	**2004**	**1,038.4**	**1,303.1**	**−264.7**	**−21.7**

Notes: *1.* Yen-denominated figures for each country are calculated using the exchange rate at year-end as published in the *International Financial Statistics* of the IMF.
2. The countries and an area listed above are the G-8 nations and those with large net assets or liabilities.
3. In China, data on the country's international investment position were released for the first time on May 25, 2006, by the State Administration of Foreign Exchange.
4. Figures for year-end 2004 are used for countries for which figures for year-end 2005 are not available.

Sources: Statistics Canada (for Canada); Office for National Statistics (for the United Kingdom); Banco de España (for Spain); IMF, *International Financial Statistics* (for other countries).

Box Estimating Direct Investment Assets and Liabilities on a Market Value Basis

Direct investment assets and liabilities estimated on a market value basis both greatly exceeded those on a book value basis, with the difference between market and book values increasing from the previous year-end. On a market value basis, assets amounted to 82.8 trillion yen, exceeding the book value by 37.2 trillion yen, whereas they exceeded the book value by 28.5 trillion yen at year-end 2004. Liabilities amounted to 26.2 trillion yen, exceeding the book value by 14.3 trillion yen, whereas they exceeded the book value by 8.4 trillion yen at year-end 2004. Assets on a market value basis increased by 15.7 trillion yen from year-end 2004, reflecting the rise in stock prices worldwide and the depreciation of the yen. Liabilities on a market value basis also increased, by 7.8 trillion yen, as a result of the rise in Japanese stock prices (Chart 1 for Box).

When the resulting figure was introduced into the overall international investment position, Japan's net asset position at year-end 2005 amounted to 203.6 trillion yen, a decrease of 2.3 trillion yen from the previous year-end (charts 2 and 3 for Box).

Chart 1 for Box Direct Investment Assets and Liabilities: Comparison between Market Value and Book Value

tril. yen

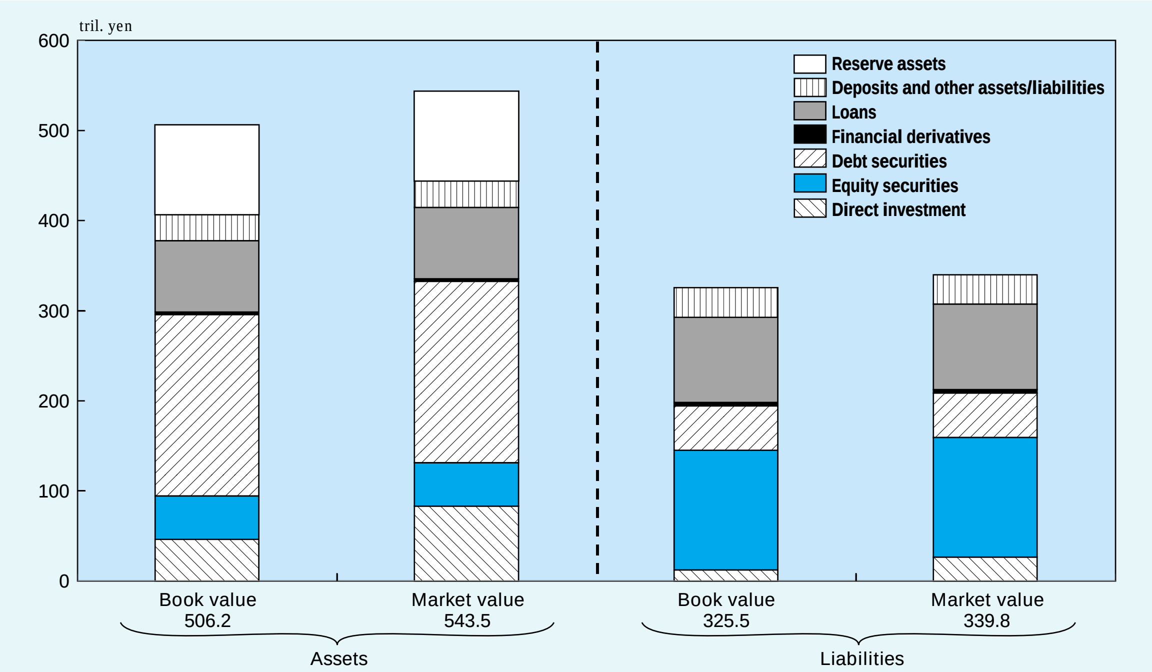
	Year-end 2004		Year-end 2005	
	Market value (estimates)	Book value	Market value (estimates)	Book value
Direct investment assets	67.1	38.6	82.8	45.6
Direct investment liabilities	18.5	10.1	26.2	11.9

Chart 2 for Box Net Assets: Comparison between Market Value and Book Value

tril. yen

	Year-end 2004		Year-end 2005		y/y chg.	
	Market value (estimate)	Book value	Market value (estimate)	Book value	Market value (estimate)	Book value
Net assets	205.9	185.8	203.6	180.7	–2.3	–5.1

Chart 3 for Box Breakdown of Assets and Liabilities by Component at Year-End 2005 (on Book and Market Value Bases)



Why Has Japanese Private Consumption Remained Firm? (Abstract)

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

Abstract[1]

1. Private consumption has been slowly recovering since around the year 2000. This recovery gradually became clearer from the second half of 2003, and its pace is now steadily increasing. The present expansion phase that began from early 2002 reached four years and three months in April 2006, rivaling the longevity of the bubble period. In examining the reasons why the ongoing recovery has lasted so long, one cannot overlook the continued firmness of private consumption together with the expansion in overseas economies and reduced structural adjustment pressures in the corporate sector.
2. The characteristics of private consumption in recent years are summarized as follows: (1) private consumption has remained firm despite significantly restrained household income under firms' strong stance toward restricting personnel expenses, and consequently the propensity to consume has been drifting upward; (2) this trend has been especially conspicuous among the elderly segment (senior citizens); and (3) by category, consumption of durable goods and services has been relatively strong. In addition, the improvement in consumption is spreading to younger age segments recently, supported by the rise in employee compensation.
3. As the background to this firmness of consumption, the underlying factors include (1) demographic factors such as aging of the population, (2) changes in consumer attitudes and efforts by firms, and (3) effects of the introduction of the nursing care insurance system. In addition, there were relatively strong influences from factors which pushed up consumption in each phase, such as (4) inertia in consumption, (5) improvement in consumer confidence and the wealth effect, and (6) improvement in actual employee compensation.
4. In this manner, private consumption has been upheld to some extent by structural and underlying factors over the past few years, and is recently becoming increasingly positive with the growth in income and assets. Estimated results of consumption function also indicate that the basis for the recent recovery in consumption has become firm, supported by such factors as the aging of the population, the rise in employee compensation, the wealth effect from higher stock prices, and the improved income outlook.
5. As for the consumption outlook, employee income is expected to keep rising, and household confidence regarding future income is projected to gradually strengthen. In addition, if the favorable performance of the corporate sector continues, this is expected to keep exerting a positive effect on consumption through such factors as higher stock prices. Furthermore, aging of the population will continue boosting the propensity to consume. Given these developments, there is a high probability that private consumption will continue to steadily expand for the time being, accompanied by a gradual rise in the propensity to consume.

1. The original version in Japanese was published on March 13, 2006.

Public Statement by the Bank of Japan

April–June 2006

May 4, 2006
Ministry of Finance of Japan, The Bank of Japan
The Bangko Sentral ng Pilipinas

Signing of the Second Bilateral Swap Arrangement between the Bangko Sentral ng Pilipinas and the Bank of Japan, as Agent for the Minister of Finance of Japan under the Chiang Mai Initiative - Second Stage

1. The Bangko Sentral ng Pilipinas (BSP) and the Bank of Japan (BOJ), acting as the agent for the Minister of Finance of Japan, signed on May 4, 2006 a second Bilateral Swap Arrangement (BSA) under the Chiang Mai Initiative (CMI). The BSA shall be effective for a three-year period and may be extended by mutual agreement between the BSP and the BOJ, as the agent for the Minister of Finance of Japan. The agreement will enable the two monetary authorities to swap their local currencies (i.e., Philippine pesos or Japanese yen) against US dollars. Under the arrangement, the BSP can swap up to US$6 billion while the Minister of Finance of Japan can swap up to US$500 million in the event that an immediate need arises that would require balance of payments or short-term liquidity support.

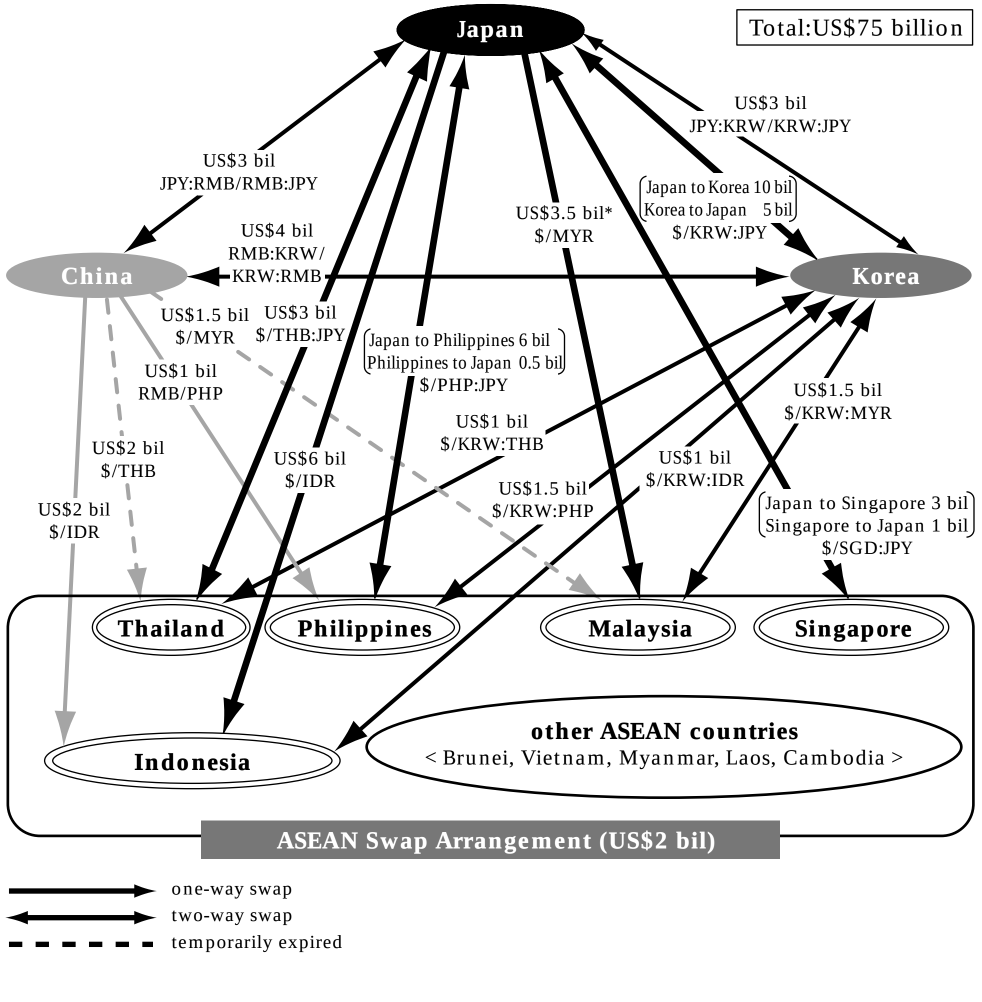
2. The BSA between the BSP and the BOJ, acting as the agent for the Minister of Finance of Japan, reflects the measures adopted by the ASEAN+3 Finance Ministers during their meeting on May 4, 2005 in Istanbul, Turkey, in pursuit of the CMI Second Stage. The CMI Second Stage aims to enhance the effectiveness of the CMI as a foreign exchange liquidity support mechanism. The one-way swap between the BSP and the BOJ, acting as the agent for the Minister of Finance of Japan, has been transformed into a two-way swap under the second BSA. The size of the swap commitment of the Minister of Finance of Japan to the two-way swap was increased from US$3 billion to US$6 billion while the BSP made a new swap commitment of US$500 million. The size of the swap that could be withdrawn without an IMF-support program was also increased from 10 percent to 20 percent of the total swap amount. In this BSA, the condition of the swap activation has been linked to Swap Requesting Party's participation in the ASEAN+3 Economic Review and Policy Dialogue.

3. The BSP and the BOJ, acting as the agent for the Minister of Finance of Japan concluded their first one-way BSA from Japan to the Philippines amounting to US$3 billion in August 2001.

4. The new BSA between the Philippines and Japan signals the continued solidarity of the ASEAN+3 member countries in promoting financial stability in the region.

See the annex figure.

The Agreement on the Swap Arrangement under the Chiang Mai Initiative (as of May 4, 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.

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).

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.

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

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 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.

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 May and July 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).

Title	Speaker	Venue	Date of speech	Date of release
■ Speeches/Summaries of Speeches by Bank Executives				
The Outlook for Japan's Economy and the Conduct of Monetary Policy[1]	Toshihiko Fukui (Governor)	Naigai Josei Chousa Kai (Research Institute of Japan) (Tokyo)	May 15, 2006	May 15, 2006
Opening Speech at the Thirteenth International Conference Hosted by the Institute for Monetary and Economic Studies	Toshihiko Fukui (Governor)	Tokyo	June 1, 2006	June 1, 2006
Recent Economic and Financial Developments and the Conduct of Monetary Policy[1]	Toshihiko Fukui (Governor)	Japan National Press Club (Tokyo)	June 20, 2006	June 20, 2006
The New Policy Framework of the Bank of Japan: Central Banking in an Uncertain World	Kiyohiko G. Nishimura (Member of the Policy Board)	Uppsala University (Uppsala)	June 27, 2006	June 28, 2006
The Conduct of Monetary Policy under the New Framework[1]	Kazumasa Iwata (Deputy Governor)	Meeting with Business Leaders (Akita)	June 8, 2006	July 7, 2006
Statement before the House of Representatives[1]	Toshihiko Fukui (Governor)	Committee on Financial Affairs (Tokyo)	June 16, 2006	July 18, 2006

Title	Author(s)	Category	Date of release
■ Bank of Japan Research Papers/Working Paper Series[2]			
Why Has Japanese Private Consumption Remained Firm?[3]	Research and Statistics Department	Research Papers	May 11, 2006
Results of the 25th Opinion Survey on the General Public's Mindset and Behavior	Public Relations Department	Research Papers	May 24, 2006
Monetary Policy Conduct of the Swiss National Bank: The Experience from 2001 to 2004	Shinsuke Ohyama and Junko Tanigawa	Working Paper Series	May 30, 2006

Notes: *1*. Published in this issue of 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.
3. An abstract of the paper is published in this issue of the *Bank of Japan Quarterly Bulletin*.

Title	Author(s)	Category	Date of release
■ Bank of Japan Research Papers/Working Paper Series[1] (continued)			
An Empirical Analysis of Price Stickiness and Price Revision Behavior in Japan Using Micro CPI Data	Katsurako Sonoda	Working Paper Series	June 1, 2006
Recent Developments in Hedge Funds[2]	Financial Systems and Bank Examination Department and Financial Markets Department	Research Papers	June 13, 2006
Japan's International Investment Position at Year-End 2005 (Summary)[3]	International Department	Research Papers	July 13, 2006
Roles of Technology and Nontechnology Shocks in the Business Cycles	Shingo Watanabe	Working Paper Series	July 24, 2006
Effects of the Quantitative Easing Policy: A Survey of Empirical Analyses	Hiroshi Ugai	Working Paper Series	July 27, 2006

Notes: *1*. The Bank introduced the series to invite comments on working papers written by the Bank's staff and outside researchers.
2. A summary of the paper is published in the May 2006 issue of the *Bank of Japan Quarterly Bulletin*.
3. Published in this issue of the *Bank of Japan Quarterly Bulletin*.