

Not to be released until 2:00 p.m.  
Japan Standard Time on Wednesday,  
September 13, 2006.

September 13, 2006

Bank of Japan

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**Minutes of the  
Monetary Policy Meeting**  
on August 10 and 11, 2006

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(English translation prepared by the Bank's staff based on the Japanese original)

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, August 10, 2006, from 2:00 p.m. to 4:13 p.m., and on Friday, August 11, from 9:00 a.m. to 12:11 p.m.<sup>1</sup>

#### **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. H. Haru**

**Mr. T. Fukuma**

**Mr. A. Mizuno**

**Mr. K. G. Nishimura**

**Mr. T. Noda**

#### **Government Representatives Present**

Mr. K. Akaba, Senior Vice Minister of Finance, Ministry of Finance<sup>2</sup>

Mr. E. Katsu, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance<sup>3</sup>

Mr. J. Hamano, Vice Minister for Policy Coordination, Cabinet Office

#### **Reporting Staff**

Mr. A. Yamamoto, Executive Director

Mr. N. Inaba, Executive Director

Mr. A. Horii, Executive Director (Assistant Governor)

Mr. M. Amamiya, Director-General, Monetary Affairs Department

Mr. S. Uchida, Senior Economist, Monetary Affairs Department

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<sup>1</sup> The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on September 7 and 8, 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.

<sup>2</sup> Mr. K. Akaba was present on August 11.

<sup>3</sup> Mr. E. Katsu was present on August 10.

Mr. H. Nakaso, Director-General, Financial Markets Department

Mr. H. Hayakawa, Director-General, Research and Statistics Department

Mr. E. Maeda, Deputy Director-General, Research and Statistics Department

Mr. T. Idesawa, Director-General, International Department

#### Secretariat of the Monetary Policy Meeting

Mr. Y. Nakayama, Director-General, Secretariat of the Policy Board

Mr. Y. Iino, Adviser to the Governor, Secretariat of the Policy Board

Mr. K. Murakami, Director, Secretariat of the Policy Board

Mr. S. Yamaguchi, Senior Economist, Monetary Affairs Department

Mr. K. Suzuki, Senior Economist, Monetary Affairs Department

## **I. Summary of Staff Reports on Economic and Financial Developments<sup>4</sup>**

### **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 July 13 and 14, 2006.<sup>5</sup> The uncollateralized overnight call rate rose temporarily after that meeting, but the market calmed swiftly due partly to the Bank's flexible conduct of funds-supplying operations. The rate had been at around 0.25 percent since late July.

### **B. Recent Developments in Financial Markets**

In the money market, interest rates on term instruments and Euroyen futures had been more or less unchanged.

Japanese stock prices declined temporarily, but rose thereafter mainly due to a rise in U.S. stock prices. The Nikkei 225 Stock Average was recently moving at around 15,500 yen.

Long-term interest rates had been more or less unchanged, although they had fluctuated slightly. Recently they were moving at around 1.9 percent.

The yen temporarily depreciated against the U.S. dollar to the 117-118 yen range, but appreciated thereafter, mainly reflecting market participants' speculation regarding U.S. monetary policy. The yen was being traded in the range of 114-116 yen to the dollar recently.

### **C. Overseas Economic and Financial Developments**

The U.S. economy continued to expand, as evidenced, for example, by continuous increases in business fixed investment and production. The pace of economic expansion was, however, decelerating, as housing investment was decreasing and the pace of growth in household spending and employment was moderating. As for prices, the consumer price index (CPI) for all items, as well as the core CPI and the core personal consumption expenditures (PCE) deflator, both of which excluded food and energy, increased moderately.

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<sup>4</sup> Reports were made based on information available at the time of the meeting.

<sup>5</sup> The guideline was as follows:

The Bank of Japan will encourage the uncollateralized overnight call rate to remain at around 0.25 percent.

The rate of increase in unit labor costs edged up.

In the euro area, the momentum for economic recovery increased, as seen in the fact that exports, production, and business fixed investment were increasing and household spending was recovering gradually against the background of the gradual improvement in the employment situation.

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

In U.S. and European financial markets, long-term interest rates declined and stock prices rose. In many emerging economies, stock prices continued to rise, reversing the decline until June.

#### **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 growth 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. With regard to sales indicators, retail sales data had been sluggish due partly to adverse weather conditions, and some indicators for consumer sentiment were also somewhat weak. However, indicators related to services consumption were favorable on the whole. Private consumption was likely to continue to increase steadily with the gradual increase in household income.

Industrial production had continued to increase on the whole against the background of the growth in domestic and external demand, although production of electronic parts and devices decreased slightly. It was expected to continue its uptrend, as overseas economies would continue to grow and domestic demand would keep expanding.

As for the employment and income situation, household income had continued rising moderately in a situation where various indicators continued to show tighter labor

market conditions. The gradual increase in household income was likely to continue against the background that firms were increasingly feeling a shortage of labor and the high level of corporate profits was being maintained.

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 continue to be 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. Credit demand in the private sector had been increasing. In this situation, 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 was around the previous year's level. Funding costs for firms had risen slightly. The year-on-year rate of change in the money stock ( $M_2$ +CDs) was at the 0.0-1.0 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 concurred that, taking into account economic indicators that were released in the intermeeting period, the economy was expanding moderately, with domestic and external demand and also the corporate and household sectors well in balance, broadly in line with the Bank's projection presented in the April *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), and they expected the economy to continue to expand moderately.

Members agreed that overseas economies taken as a whole continued to expand and were likely to keep expanding. They added, however, that they should watch carefully how adjustment in the U.S. economy toward a soft landing was proceeding.

On the U.S. economy, members concurred that, although it continued to expand,

the pace of expansion was decelerating. Members also agreed that inflation pressures persisted as seen in continued rises in the core CPI and the core PCE deflator. Many members said that hourly earnings were rising and the revised data for U.S. productivity and costs confirmed acceleration of the rate of increase in unit labor costs. They commented that more attention should therefore be paid to whether the slowing of the U.S. economy would swiftly lead to containment of inflation pressures. In relation to the assessment of productivity, one member commented that, given the deceleration in the rate of increase in business fixed investment, particularly in high-tech equipment, it seemed too optimistic to expect that productivity would keep rising at its recent pace.

With regard to East Asian economies, some members noted that both domestic and external demand continued to expand strongly in China. On European economies, one member said that the momentum for a recovery had been increasing as seen in the fact that exports and production were growing and household spending was recovering. A few members commented that economic fundamentals in emerging economies had been firm.

Many members expressed the view that one factor behind the recent rises in crude oil prices was heightened geopolitical risks as well as the strength in global demand, and therefore members should be mindful that the geopolitical risks had the potential to destabilize the world 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, with the continuing growth in domestic and external demand and the high level of corporate profits, business fixed investment was likely to keep increasing as suggested by the upward trend of leading indicators, such as machinery orders. Based on this view, some members said that it was necessary to examine carefully whether there was a possibility of business fixed investment becoming excessive, eventually precipitating a larger economic downturn, and whether strong investment plans, especially those of IT-related firms, were consistent with projected corporate profits and demand. A different member commented that, if firms' investment plans were generally revised further upward, it might suggest that either the potential growth rate of the economy was higher than expected, or that the economic

expansion would mature later than expected, and at present the latter seemed more likely.

Members shared the view that private consumption, which had been on an increasing trend, was likely to continue to increase, mainly reflecting a gradual increase in household income. Some members noted that, while indicators related to services consumption continued to increase, some sluggishness was being observed in indicators related to retail sales and consumer sentiment. They commented that the sluggishness seemed to be basically due to adverse weather conditions and the weakening of consumer sentiment resulting, for example, from the fall in stock prices, but developments in private consumption needed to be watched closely. Meanwhile, one member pointed out that the economic recovery might be affecting different income groups differently, and if this was the case, the positive influence of favorable business performance on private consumption might be weaker than expected.

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. In the case of electronic parts and devices, however, many members pointed out that while production had decreased, inventories were recently accumulating somewhat relative to shipments. They said that this was partly due to temporary production adjustment mainly in East Asia and postponement of the introduction of new products, but given the rapid pace of expansion globally in supply of IT-related goods, the risk of larger-scale adjustment should be noted.

With regard to the employment and income situation, members agreed that household income had continued rising moderately in a situation where labor market conditions continued to tighten and the number of employees, particularly full-time employees, continued to increase steadily.

Some members said that corporate profits were generally high, even though favorable business performance in the April-June quarter was partly a result of the weaker yen. A different member commented that forecasts of corporate profits for fiscal 2006 needed to be examined cautiously, taking into account the effects of, for example, developments in the U.S. economy, high materials prices, and increased depreciation expenses. The member continued that it should be borne in mind that, unlike in fiscal 2005, forecasts might not continue to be revised upward this year.

Members agreed that the first preliminary estimates of GDP statistics for the April-June quarter indicated steady growth in private consumption and business fixed investment, although the growth rate of real GDP was somewhat lower than expected, and this confirmed that Japan's economy was expanding steadily led by domestic private demand.

With regard to prices, members agreed that domestic corporate goods prices continued to increase rapidly, due mainly to the rise in prices of international commodities such as crude oil and nonferrous metals, and 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 continued to be positive. One member said that it should be noted that the rate of increase in prices of goods other than those that were energy-related was relatively low. Another member pointed out, however, that an increasing number of items were contributing to the rise in the CPI. Regarding the revised CPI to be released later in the month, many members commented that the Bank would not need to change its current assessment of price developments if the degree of divergence from the 2000 base-year figure was basically in line with its expectations. One member pointed out that some survey results suggested that the inflation rate expected by consumers was rising, and commented that developments in consumers' expectations required close monitoring.

As for land prices, one member pointed out that, in terms of the appraised value of land facing a thoroughfare, the year-on-year rate of change in the average land price nationwide had turned positive for the first time in 14 years. The member expressed the view that although land prices seemed to be generally consistent with the expected return, careful monitoring was required of developments.

## **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. One member said that the pace of increase in the amount outstanding of lending by private banks was accelerating due to an increase in credit demand in the private sector against the background of economic expansion. The member continued that, despite this acceleration,

the pace of increase in the money stock ( $M_2$ +CDs) was decelerating partly due to the ongoing shift of funds from bank deposits to other types of financial assets in a situation where the rate of return on financial assets other than bank deposits was improving and the Japanese financial system had regained stability. The member expressed the view that the slower pace of increase in the money stock was compatible with moderate price increases and sustainable economic growth.

Some members commented that stock prices had regained stability after the unstable movements that started in the middle of May, but possible effects of geopolitical risks continued to warrant careful attention.

### **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 around 0.25 percent.

Members concurred that financial markets had been generally stable since the policy change in July. Members agreed that the Bank had been smoothly controlling the levels of interest rates in the money market overall, although the uncollateralized overnight call rate had risen temporarily in July. As the background to this, they noted that financial institutions had gradually become more active in extending credit thereafter and the Bank's flexible money market operations had been effective. Some members noted that interest rates on term instruments and long-term interest rates had also been stable.

Regarding a factor that contributed to the generally smooth policy shift in July, many members expressed the view that the new framework for the conduct of monetary policy introduced in March had functioned effectively in communication with market participants, and the Bank's message stated in, for example, the Outlook Report had been understood well by market participants.

Many members said, however, that the functioning of the money market was still not fully restored. Some of these members commented that, to improve the situation, credit lines needed to be established and expanded further and same-day-start collateralized transactions needed to be used more frequently. Some members said that yen-carry trades might have been affecting the formation of interest rates in the money market, and thus the

Bank should gather information about developments in yen-carry trades, although it was difficult to obtain an accurate picture.

Many members said that the Bank should maintain the basic loan rate of the complementary lending facility at 0.4 percent as at present in view of the level of use of the facility and developments in the general collateral (GC) repo rate.

Regarding the future path of monetary policy, members said that the Bank would conduct monetary policy by carefully assessing economic activity and prices. Members concurred that, if 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. In other words, the Bank would adjust the level of the policy interest rate gradually in the light of developments in economic activity and prices, and in this process, an accommodative monetary environment ensuing from very low interest rates would probably be maintained for some time.

One member said that given that the growth of demand and supply in the economy was balanced and excess demand seemed unlikely to expand in the near future, the current level of the policy interest rate was appropriate and the Bank should adjust the level gradually.

With regard to the Bank's communication of its thinking regarding the future conduct of monetary policy, members agreed that since the new framework for the conduct of monetary policy had been effective, the Bank should continue to communicate its assessment of developments in economic activity and prices and its thinking about the conduct of monetary policy based on this framework through, for example, its Outlook Report. Some members noted that the public was focusing on whether the Bank would raise the level of the policy interest rate in 2006. They said that it was important that the Bank explain carefully that the timing of any policy change depended on developments in economic activity and prices and that it had no predetermined view regarding the future path of monetary policy at this point.

#### **IV. Remarks by Government Representatives**

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

- (1) Japan's economy was recovering. However, attention should be paid to the effects of developments in crude oil prices on domestic and overseas economies. A

comprehensive review of developments in prices suggested that the overcoming of deflation was coming into prospect.

- (2) Since there was currently no concern about inflation, the government considered that it was important that the Bank firmly supported the economy from the financial side.
- (3) The government would therefore like the Bank to maintain the current guideline for money market operations for the immediate future, while carefully monitoring economic activity and prices.
- (4) In order to prevent financial markets from becoming unstable due to speculation regarding future monetary policy, the government would like the Bank to give due consideration to developments in financial markets and clearly explain its thinking regarding the future course of monetary policy to market participants and the public in line with the decision at the previous meeting.

The representative from the Cabinet Office made the following remarks.

- (1) Although Japan's economy was recovering, a close watch needed to be kept on price movements. According to the first preliminary estimates of GDP for the April-June quarter released on August 11, the real GDP growth rate was 0.2 percent on a quarter-on-quarter basis, and 0.8 percent on an annualized quarter-on-quarter basis. The nominal GDP growth rate was 0.3 percent on a quarter-on-quarter basis, and 1.1 percent on an annualized quarter-on-quarter basis. The GDP deflator continued to exhibit a year-on-year decrease.
- (2) In order to ensure the overcoming of deflation during the concentrated consolidation period and achieve sustainable economic growth led by private demand with price stability, it was important for the government and the Bank to make joint efforts. The government would accelerate and deepen structural reforms based on "Basic Policies for Economic and Fiscal Management and Structural Reform 2006." It would like the Bank to implement effective monetary policy that was consistent with the government's policy efforts and with its outlook for the economy while paying due consideration to developments in financial markets, and thereby support the economy from the financial side responsibly.
- (3) As for the future path of monetary policy, the Bank had stated that an accommodative monetary environment ensuing from very low interest rates would probably be

maintained for some time. To prevent financial markets from becoming unstable due to uncertainty about the Bank's future conduct of monetary policy, the government would like the Bank to clearly explain its outlook for economic activity and prices as well as the future course of monetary policy, so as to make it easier for market participants and the public to form an economic outlook.

## 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 around 0.25 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 around 0.25 percent.

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

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 a unanimous vote, the text of "The Bank's View." It was confirmed that "The Bank's View" would be published on August 11, 2006 and the whole report on August 14, 2006.<sup>6</sup>

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<sup>6</sup> The English version of the whole report was published on August 15, 2006.

**VII. Approval of the Minutes of the Monetary Policy Meeting**

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of July 13 and 14, 2006 for release on August 16, 2006.

Attachment

August 11, 2006

Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by a 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 around 0.25 percent.