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Japan Standard Time on Wednesday,
October 18, 2006.

October 18, 2006

Bank of Japan

Minutes of the Monetary Policy Meeting

on September 7 and 8, 2006

(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, September 7, 2006, from 2:00 p.m. to 4:18 p.m., and on Friday, September 8, from 9:00 a.m. to 12:32 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. 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 Finance²

Mr. E. Katsu, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance³

Mr. B. Fujioka, Director General for Economic and Fiscal Management, Cabinet Office

Reporting Staff

Mr. N. Inaba, Executive Director

Mr. K. Ido, 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

¹ The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on October 12 and 13, 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 September 8.

³ Mr. E. Katsu was present on September 7.

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. N. Oda, Senior Economist, Monetary Affairs Department

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

I. Summary of Staff Reports on Economic and Financial Developments⁴

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 August 10 and 11, 2006.⁵ The uncollateralized overnight call rate had been at around 0.25 percent.

B. Recent Developments in Financial Markets

In the money market, interest rates on term instruments had been more or less unchanged. Interest rates on Euroyen futures fell, particularly for those with distant contract months.

Japanese stock prices rose partly reflecting favorable corporate results, but then declined due mainly to a fall in U.S. stock prices. The Nikkei 225 Stock Average was recently at around 16,000 yen.

Long-term interest rates fell, and were at around 1.7 percent recently.

The yen had been more or less unchanged against the U.S. dollar. It was being traded in the range of 115-117 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 the pace of growth in private consumption and employment was moderating and housing investment was decreasing gradually. As for prices, the pace of increase in the consumer price index (CPI) for all items was relatively fast due to high energy prices, and the core inflation rate (the CPI for all items less food and energy) increased moderately. The rate of increase in unit labor costs edged up.

In the euro area, economic recovery had generally become evident. The pace of growth in business fixed investment was accelerating with the continued increases in exports and production. In addition, private consumption was recovering, as the

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 around 0.25 percent.

employment situation continued to improve gradually reflecting high corporate profits.

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

In U.S. and European financial markets, long-term interest rates declined and stock prices rose. In many emerging economies, financial markets generally remained firm, as evidenced, for example, by the rise in stock prices.

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 taken as a whole continued to expand.

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.

Production as a trend had continued to increase against the background of the growth in domestic and external demand. Industrial production was flat in July compared to the monthly average of the April-June quarter, but this was due to a temporary fall in production of items that tended to fluctuate substantially. The upward trend was expected to continue, as overseas economies continued to grow and domestic demand kept expanding. Inventories had been in balance with shipments as a whole.

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) remained on a positive trend, although the recent rebasing of the index caused divergence of the new 2005 base-year series from the 2000 base-year series. The positive 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 started to increase. In this situation the amount outstanding of lending by private banks had been increasing, 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 the interim assessment made public in July. They also agreed that the economy was likely to continue to expand moderately, in an environment in which a virtuous cycle of production, income, and expenditure would operate.

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 toward a soft landing was proceeding in the U.S. economy.

On the U.S. economy, members concurred that, although it continued to expand, the pace of expansion was decelerating. Many members noted that the decrease in housing investment was becoming more evident. Some of these members expressed the view that these developments were generally in line with expectations and the economy was in the process of adjustment toward a soft landing. Some other members commented that developments in housing investment warranted attention since a substantial decrease could be a downside risk to the economic outlook. With regard to prices, members agreed that inflation pressures persisted as seen in continued rises in the core CPI and the core personal consumption expenditures (PCE) deflator. Some members pointed out that the increase in unit labor costs continued to exert inflation pressure, and commented that they would also pay attention to how the fall in energy prices affected general prices. Many members said that whether the slowing of the U.S. economy contained inflation pressures should continue to be watched closely.

With regard to European economies, some members said that economic recovery had become evident, as seen in the fact that private consumption was recovering as exports and production increased. On East Asian economies, some members noted that both domestic and external demand continued to expand strongly in China. One member commented that the NIEs and ASEAN economies continued to expand at a moderate pace on the whole.

Many members pointed out that crude oil prices had recently started to fall partly because geopolitical risks had ceased to heighten further. They noted, however, that crude oil prices remained at high levels due partly to continuing uncertainty about the geopolitical situation and the strength in global demand, and expressed the view that the effects of high crude oil prices on the world economy continued to warrant attention.

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, reflecting the continuing growth in domestic and external demand and the high level of corporate profits. Some members commented that this forecast was supported by figures for the April-June quarter in the *Financial*

Statements Statistics of Corporations by Industry, Quarterly. One member said that the firmness in business fixed investment was seen in a wide range of industries. Based on these assessments, a few members commented that they would continue to pay attention to whether there was a possibility of an acceleration of business fixed investment causing large economic swings. One member said that it was necessary to watch carefully whether strong investment plans, especially those of IT-related firms, were consistent with projected corporate profits and demand. A different member noted that business fixed investment of small and medium-sized firms was not as strong as that of large firms, and said that the member would watch carefully developments in business fixed investment, including the results of the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan).

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, such as outlays for travel and sales in the food service industry, continued to increase, some sluggishness was being observed in indicators related to retail sales and consumer sentiment. They pointed out that the sluggishness seemed to be largely due to temporary factors such as adverse weather conditions, and commented that developments in private consumption after these factors fell off warranted attention. Many members said that the strength in the corporate sector had been relatively slow in benefiting the household sector to date.

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. Some members referred to industrial production for July and said that it was not necessary to change the assessment that production was on an uptrend. 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 expressed the view that close monitoring was still necessary of developments in their inventories, which were accumulating somewhat relative to shipments. On this point, some members said that inventories of electronic parts and devices had increased partly because firms had accumulated them in anticipation of future demand, for example, Christmas sales. A few members commented that, compared to past adjustment phases of IT-related goods, current fluctuations in their shipments were not especially large. One member noted that the

correlation between developments in inventories of electronic parts and devices and those of other goods had become weak, and expressed the view that the risk of inventory adjustment of electronic parts and devices spreading to other industries was small.

As for the employment and income situation, members agreed that labor market conditions continued to tighten and the number of employees, particularly full-time employees, continued to increase steadily. Regarding wages, some members referred to the fact that regular payments had been somewhat weak recently, and said that this was against the background that firms were still restraining labor costs. In this regard, a few members commented that firms were increasingly feeling a shortage of labor and that this might affect regular payments in the future. Members agreed that wages as a whole, including overtime payments and special payments, were likely to continue increasing gradually.

With regard to prices, members agreed that domestic corporate goods prices were increasing 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) had been on a positive trend in the 2005 base-year series as in the 2000 base-year series, and that it was likely to continue to follow a positive trend, as the output gap continued to be positive. One member expressed the view that, looking at price movements by item, inflation pressures were not strengthening for goods other than energy-related ones. Another member, on the other hand, said that prices of an increasing number of items were rising. Members commented on the revision of the CPI from the 2000 base-year series to the 2005 base-year series that negative divergence from the 2000 base-year series in the year-on-year rate of change was somewhat larger than generally expected, but agreed that the Bank's basic assessment of prices did not need to be changed following the revision. With regard to the causes of the larger-than-expected negative divergence, some members pointed out that, although the effects of re-indexing and of including new items in the CPI basket were basically within the expected range, the effects of changes in the calculation of indices for existing items in the CPI basket, such as mobile telephone charges, might have been significant. These members continued that most of the effects on the CPI of the changes in the calculation of indices for existing items were likely to cease one year after those effects had started to appear. One member commented

that the rebasing of the CPI had increased the weights of items undergoing rapid technological innovation and deregulation in the CPI basket, and the member would pay attention to how this increase affected developments in the CPI. Another member said that, compared to the 2000 base-year series, the year-on-year rate of change in the CPI was lower in the 2005 base-year series, but the uptrend in the year-on-year rate of change since the beginning of 2006 was more evident.

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 accommodative. Some members said that the amount outstanding of lending by private banks continued to increase in a situation where credit demand in the private sector had started increasing. A few members commented that the pace of increase in the money stock (M_2 +CDs) was relatively slow despite the increase in lending, 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 these assets was improving and the Japanese financial system had regained stability. They expressed the view that the slow pace of increase in the money stock was compatible with moderate price increases and sustainable economic growth. One member said that the financial environment could also be considered accommodative given that the level of real interest rates was low relative to the real GDP growth rate.

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 previous meeting. Members agreed that interest rates in the money market had been kept smoothly under control overall, as evident in the weighted average of the uncollateralized overnight call rate, which moved in a range of a few basis points below and above 0.25 percent. As the background to this, some members noted that the Bank's flexible money

market operations had been effective, and concerns about market financing had eased. A few members said that market participants had become accustomed to trading in the current financial environment. One member pointed out that there was limited use of the complementary lending facility in the intermeeting period, and commented that this was due to the fact that the general collateral (GC) repo rate had generally been at around 0.3 percent, well below the current 0.4 percent loan rate applied to the facility (the basic loan 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. They also agreed 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.

As for the effect of the recent rebasing of the CPI, members affirmed that the "understanding of medium- to long-term price stability" in the new framework for the conduct of monetary policy should not be affected by the rebasing, because the understanding covered the medium to long term.

With regard to the Bank's communication of the outlook for prices, one member said that it would be beneficial to use the chain-weighted CPI as well, because it was less affected by re-indexing. Some members expressed the view that, although use of the chain-weighted CPI might have some advantages, the Bank had to consider such disadvantages as the fact that its release lagged behind the currently used fixed-weight CPI and it was relatively unfamiliar to the public.

IV. Remarks by Government Representatives

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

- (1) Japan's economy was recovering. The corporate sector showed strength as seen in firmness in business fixed investment, but some indicators related to private consumption were sluggish due partly to adverse weather conditions. Attention should be paid to the effects on the economy of developments in crude oil prices and overseas economies. A comprehensive review of developments in prices suggested that the

overcoming of deflation was coming into prospect.

- (2) In the current situation where there was no concern about inflation and figures for the year-on-year rate of increase in the CPI had been revised downward due to the recent rebasing of the CPI, the government considered that it was important that the Bank maintain the current guideline for money market operations and firmly support the economy in order to ensure the sustainability of the economic recovery.
- (3) The government would like the Bank to give due consideration to developments in financial markets. In order to prevent the 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 and to promote proper formation of expectations.

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.
- (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 1).

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 September 8, 2006 and the whole report on September 11, 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 August 10 and 11, 2006 for release on September 13, 2006.

⁶ The English version of the whole report was published on September 12, 2006.

VIII. Approval of the Scheduled Dates of the Monetary Policy Meetings in October 2006-March 2007

At the end of the meeting, the Policy Board approved the dates of the Monetary Policy Meetings to be held in the period October 2006-March 2007, for immediate release (see Attachment 2).

Attachment 1

September 8, 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.

September 8, 2006

Bank of Japan

**Scheduled Dates of Monetary Policy Meetings
in October 2006-March 2007**

	Date of MPM	Publication of Monthly Report (The Bank's View)	Publication of MPM Minutes
Oct. 2006	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.)	Jan. 23 (Tue.)
Jan. 2007	17 (Wed.), 18 (Thur.)	18 (Thur.)	Feb. 26 (Mon.)
Feb.	20 (Tue.), 21 (Wed.)	21 (Wed.)	Mar. 26 (Mon.)
Mar.	19 (Mon.), 20 (Tue.)	20 (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).