Not to be released until 2:00 p.m. Japan Standard Time on Tuesday, November 21, 2006.

November 21, 2006

Bank of Japan

Minutes of the Monetary Policy Meeting

on October 12 and 13, 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, October 12, 2006, from 2:00 p.m. to 4:09 p.m., and on Friday, October 13, from 9:00 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. H. Haru

Mr. T. Fukuma

Mr. A. Mizuno

Mr. K. G. Nishimura

Mr. T. Noda

Government Representatives Present

Mr. K. Tanaka, Senior Vice Minister of Finance, Ministry of Finance[2]

Mr. E. Katsu, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance[3]

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

Reporting Staff

Mr. N. Inaba, Executive Director

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

Mr. K. Ido, Executive Director

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

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

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[1] The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on November 15 and 16, 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. Tanaka was present on October 13.

[3] Mr. E. Katsu was present on October 12.

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. T. Kato, Director, Monetary Affairs Department[4]

Mr. N. Oda, Senior Economist, Monetary Affairs Department

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

Mr. H. Koguchi, Director, Financial Markets Department[4]

[4] Messrs. T. Kato and H. Koguchi were present on October 13 from 9:00 a.m. to 9:19 a.m.

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 September 7 and 8, 2006.[6] The uncollateralized overnight call rate had generally been at around 0.25 percent during the intermeeting period, although it rose temporarily to 0.339 percent on September 29, which was the day of the first semiannual book closings after the Bank brought the zero interest rate environment to an end.

B. Recent Developments in Financial Markets

In the money market, interest rates on term instruments had been more or less unchanged. Due mainly to speculation regarding the timing of a rise in the policy rate, interest rates on Euroyen futures fell from mid-September through late September and rebounded somewhat thereafter; as a result, they had changed little since the previous meeting.

Japanese stock prices were somewhat weak during September due partly to the release of some weaker-than-expected economic indicators. However, they rose thereafter, as some economic indicators released since late September confirmed the firmness in Japan's economy. The Nikkei 225 Stock Average was recently at around 16,500 yen.

Long-term interest rates dropped to around 1.6 percent in the face of some weaker-than-expected economic indicators and the decline in U.S. interest rates, but rose thereafter with the release of firm domestic economic indicators. They were recently in the 1.7-1.8 percent range.

The yen had generally been on a depreciating trend against the U.S. dollar reflecting interest rate differentials between Japanese and overseas markets, although it rose temporarily in late September to the 116-117 yen level due to some weaker-than-expected U.S. economic indicators. It was being traded in the range of 118-120 yen to the dollar recently.

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[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 around 0.25 percent.

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. As for prices, the pace of increase in the consumer price index (CPI) for all items moderated with the fall in energy prices, but the core inflation rate (the CPI for all items less food and energy) continued to increase moderately, reflecting tighter supply-demand conditions due to the economic expansion. The rate of increase in unit labor costs edged up.

In the euro area, economic recovery had become evident, as the increase in production and improvement in corporate profits had led to recovery in business fixed investment and private consumption. The U.K. economy had returned to a stable growth path.

With regard to East Asian economies, in China both domestic and external demand continued to expand strongly. The rate of increase in fixed asset investment remained high, although it was recently slowing somewhat. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole, although the negative effects of past rises in energy prices remained in some economic activity.

In U.S. and European financial markets, long-term interest rates declined and stock prices rose, partly because market participants perceived the fall in energy prices as a positive factor that would reduce inflation pressures. In many emerging economies, financial markets generally remained firm, as evidenced 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. Sales at department stores and supermarkets were relatively sluggish from the spring to around July, dampened by unfavorable weather. However, sales particularly for apparel had picked up since August, when the weather improved. As for services consumption, sales in the food service industry had been on a steady uptrend, and outlays for travel had been firm. Private consumption was likely to continue to increase steadily mainly reflecting the gradual increase in household income.

Production had continued to increase against the background of the growth in domestic and external demand. The upward trend was expected to continue as overseas economies continued to grow and domestic demand kept expanding. Anecdotal information suggested that production was likely to increase further in the October-December quarter. 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 corporate profits were expected to remain high.

On the price front, crude oil prices had dropped sharply since mid-August against the background of the easing of geopolitical risks, and were recently at levels observed in the spring. Domestic corporate goods prices had been increasing, reflecting past rises in international commodity prices. However, the pace of increase was expected to slow in the immediate future, due to the recent drop in crude oil prices. The year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) had been on a positive trend. This trend was projected to continue, as the output gap continued 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. Under these circumstances, the amount outstanding of lending by private banks had been increasing. The amount outstanding of CP and corporate bonds issued was slightly below 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. Amendment to Margin Tables for Eligible Collateral

A. Staff Proposal

The staff proposed that the Bank amend Guidelines on Eligible Collateral and the principal terms and conditions for repo operations and securities lending to revise the margin tables. This proposal was put forward in view of the fact that approximately a year had passed since they were last amended in September 2005, and developments in financial markets such as the volatility of market interest rates since then were reflected in the proposed amendment.

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 concurred that, taking into account economic indicators that were released in the intermeeting period, including figures in the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the economy continued to expand moderately, broadly in line with the Bank's projection presented in the April *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), albeit with a somewhat stronger corporate sector and a somewhat weaker household sector than in the April projection. They also agreed that the economy was likely to continue to expand moderately, in an environment in which a virtuous circle of production, income, and expenditure would operate.

Members agreed that, although they should watch carefully how adjustment toward a soft landing was proceeding in the U.S. economy, overseas economies taken as a whole continued to expand across a broader range of regions, and were likely to keep expanding.

On the U.S. economy, members concurred that, although it continued to expand, the pace of expansion was decelerating. Some members said that the deceleration was moderate on the whole, as seen in the fact that, while housing investment was decreasing, so far business fixed investment and production continued to increase and the deceleration of growth in private consumption and employment was moderate. As for the outlook, members agreed that, given the decline in crude oil prices, the scenario of a soft landing with inflation pressures gradually abating as the economy decelerated moderately was becoming more likely to materialize. Many members added that the risk that inflation might accelerate should continue to be watched closely, since some inflation risks remained as seen in continued rises in the core inflation rate. Some members said that they would continue to pay attention to developments in the U.S. economy since there was some uncertainty regarding the extent to which the adjustment in the housing market would affect private consumption and the risk of a further deceleration in the economy was not negligible. One member commented that, judging from indicators released to date, the growth rate of the U.S. economy for the July-September quarter was likely to be lower than market expectations.

With regard to European economies, members agreed that economic recovery had become evident, as seen in the fact that private consumption was recovering as exports and production increased. One member commented that attention should continue to be paid to the cumulative effects of the raising of the policy interest rates by the European Central Bank (ECB) and the effects of the recent appreciation of the euro.

On East Asian economies, members concurred that both domestic and external demand continued to expand strongly in China and the NIEs and ASEAN economies continued to expand at a moderate pace on the whole. A few members pointed out that, in the *World Economic Outlook* released in September 2006 by the International Monetary Fund (IMF), the forecast for global growth was revised upward from that made in April, as the contribution of upward revision of growth in emerging economies, particularly the BRIC economies, exceeded that of downward revision of U.S. growth. One of these members added that emerging economies including those in Asia might have become more self-sustained than before. A different member said that it should be examined closely whether, in the event the U.S. economy decelerated rapidly, the world economy, including emerging economies, could continue to expand or would inevitably be slowed.

A few members expressed the view that the recent decline in crude oil prices reflected adjustments to speculative activities prevalent until recently, in addition to the abatement of concerns about geopolitical risks. These members said that if this view was correct, the fall in crude oil prices could be seen as a positive factor for the world economy. A different member commented that the decline in crude oil prices could be limited while the world economy continued to expand. Based on these discussions, members concurred that future developments in crude oil prices and their effects on the world economy continued to warrant attention, given that crude oil prices remained at high levels and supply concerns stemming from such factors as geopolitical risks had not been dispelled completely.

Regarding Japan's economy, members agreed that the increase in exports had continued, reflecting the expansion of overseas economies, and was likely to continue. Some members referred to the fact that the diffusion index for manufacturers' perception of overseas supply-demand conditions for products in the September *Tankan* was slightly positive for both the actual result and the forecast, and commented that the slowing of the U.S. economy did not seem to be affecting demand for Japanese products markedly at least at this point.

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 corporate profits continued to be at high levels. A few members referred to firms' expectation of current profits for fiscal 2006 in the September *Tankan*. These members were of the view that, for the following reasons, current profits were likely to turn out significantly higher than expected at the book closing. First, when projecting their profits, firms assumed a considerably stronger yen than the actual level against the U.S. dollar. And second, even when profits for the first half of the fiscal year turned out higher than expected, in the September survey firms tended to keep their projection for the whole fiscal year unchanged by revising the projection for the second half downward. Members agreed that business fixed investment, which continued to increase, was likely to keep increasing, reflecting the continuing growth in domestic and external demand and the high level of corporate profits. With regard to business fixed investment plans for fiscal 2006 in the September *Tankan*, some members said that the plans were steadily being revised upward and the rate of growth was likely to eventually be around the previous year's level, which had represented a high rate of growth. One member noted that business sentiment and business fixed investment at small firms were somewhat weaker than at large firms. This member commented that this could be regarded not only as indicating slowness in the diffusion of positive effects of economic improvement, but also as the result of existing structural problems in some industries.

Members shared the view that private consumption, which had been on an increasing trend, was likely to continue to increase steadily mainly reflecting the gradual increase in household income. Some members said that the improvement in many indicators since August suggested that the sluggishness in indicators for July was largely due to temporary factors such as unfavorable weather. A few members noted that indicators for consumer sentiment had barely improved and there was a polarization of sales toward expensive goods and low-priced goods. They continued that the strength in the corporate sector had been relatively slow in benefiting the household sector and private consumption could be described as increasing steadily but not vigorously.

Members agreed that production had continued to increase and was likely to continue to be on an increasing trend 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. Regarding inventories of electronic parts and devices, some members said that attention should continue to be paid to the possibility that shipments might fall depending on private consumption in the United States, thereby increasing adjustment pressure on inventories again. These members added, however, that even if such pressure were to increase again, a large inventory adjustment was unlikely because the current level of inventories relative to shipments was not especially high.

As for the employment and income situation, members agreed that the number of employees, particularly full-time employees, continued to increase steadily against the background that labor market conditions continued to tighten and firms were increasingly feeling a shortage of labor. Regarding the recent sluggishness in regular payments, an element of wages, a few members said that the weakness in the statistics might be partly attributable to changes in the age structure of the workforce in firms as a result of retirement of baby boomers and increased recruitment of new graduates, and that wages being paid to individual employees might have actually been increasing steadily. A few other members commented that, although the increase in the recruitment of new graduates might have had some effect, more basically the sluggishness of regular payments might be largely due to the fact that firms were still restraining labor costs. One of these members added that households' view of income growth in the Cabinet Office's *Consumer Confidence Survey* had improved very little. Many members including these members expressed the view that firms were increasingly feeling a shortage of labor and that this would affect regular payments sooner or later. Based on these discussions, members concurred 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 had been increasing, reflecting past rises in international commodity prices. They said, however, that the pace of increase was expected to slow in the immediate future, due to the recent drop in prices of international commodities such as crude oil. A few members commented that the diffusion index for manufacturers' perception of changes in output prices had become positive in the September *Tankan* and the pricing power of firms was recovering significantly. One of these members said that the corporate service price index for all items was higher than a year earlier for the first time in eight and a half years, and a rise in prices for both goods and services traded in the corporate sector had become evident.

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, and that it was likely to continue to follow a positive trend, as the output gap continued to be positive. A few members enumerated both negative and positive factors that would contribute to future year-on-year changes in the CPI: while the positive contribution of petroleum products would fade, the weakness of the yen, the increase in medical treatment costs paid by the elderly, and the disappearance of the negative contribution from the previous year's fall in mobile telephone charges would have a positive effect. These members concluded that, in sum, the positive trend in the CPI was likely to continue. A few members pointed out diffusion indices in the September *Tankan* indicating that more firms in retailing and services for individuals were expecting their sales prices to continue increasing. One member said that attention should be paid to the possibility that the positive contribution of the rise in petroleum products might fade earlier than expected, reflecting the drop in crude oil prices. A different member expressed the view that, looking at price movements by item, inflation pressures were not strengthening markedly for goods and services other than energy-related ones, and said that the member would therefore keep a closer watch on developments in the CPI.

With regard to land prices, some members noted the following: in the three major metropolitan areas (Tokyo, Osaka, and Nagoya), both commercial and residential land prices rose for the first time in 16 years; and in other areas, the fall in land prices continued but slowed moderately. A few of these members said that land purchasing expenses forecasts for fiscal 2006 in the September *Tankan* were significantly stronger than those for fiscal 2005 at the time of the September 2005 survey. They continued that this confirmed that firms had become markedly more active in land transactions.

B. Financial Developments

On the financial front, members reaffirmed their view that the financial environment remained as accommodative as it was before the Bank brought the zero interest rate environment to an end based on the following facts. First, according to the September *Tankan*, the financial positions of firms and the lending attitude of financial institutions as perceived by firms continued to be accommodative both at large and small firms. Second, conditions in financial markets in recent months were becoming more accommodative with the decline in long-term interest rates, the rise in stock prices, and the depreciation of the yen. And third, the level of real interest rates was significantly lower relative to the real GDP growth rate. One member added that, in assessing how accommodative financial conditions were, not only the level of investment costs, namely, real interest rates, but also that of investment profitability, such as expected rates of return on capital, should be considered, because firms compared marginal revenues from investment with the cost of capital when considering investing in fixed assets. A different member noted that the yen, in terms of the real effective exchange rate, had fallen as low as around the time of the conclusion of the Plaza Accord. Some members including these members said that, given the extremely accommodative financial environment, attention should be paid to various risks that might eventually cause larger economic swings, an example being that expectations might take hold that interest rates would remain low for a long time regardless of economic activity and prices.

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 around 0.25 percent.

Members concurred that the money market had been generally stable. Members noted the fact that the weighted average of the uncollateralized overnight call rate had been at around 0.25 percent, and agreed that the Bank had managed the interest rate well overall. A few members said that market participants had become accustomed to trading in the current financial environment. One member, referring to the fact that the use of the complementary lending facility had increased on the day of semiannual book closings, expressed the view that the current loan rate applied to the facility (the basic loan rate) might be slightly too low. A different member said that not only the Bank's flexible conduct of money market operations but also the presence of the complementary lending facility had contributed to the recent stability of the money market, even on September 29, the day of the first semiannual book closings after the Bank brought the zero interest rate environment to an end.

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 that the Bank would adjust the level of the policy interest rate gradually in the light of developments in economic activity and prices. 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.

Many members said that, because some economic indicators tended to fluctuate widely and often deviated noticeably from the underlying trend in the short term, they should be assessed appropriately taking their characteristics fully into consideration. These members also called attention to the point that a temporary swing of an indicator could cause the market and the Bank to have different views on economic activity and prices. In this regard, one member said that the Bank should continue to explain carefully that the rebasing of the CPI from a 2000 base to a 2005 base and the consequent negative divergence from the 2000 base in the inflation rate did not mean that its basic assessment of prices needed to be changed. Following this comment, members reaffirmed the importance of explaining thoroughly to the market and the public its assessment of economic and financial developments and its basic thinking about the conduct of monetary policy. One member commented that the next issue of the Outlook Report was very important in terms of the Bank's communication with the market, and therefore the member would like to discuss in depth at the next meeting what messages should be included in it.

V. 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 private consumption was somewhat weak recently. The effects on the economy of developments in crude oil prices and overseas economies should be watched closely. 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, 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 the effects on price movements of developments in overseas economies.

(2) In order to ensure price stability during the concentrated consolidation period and achieve sustainable economic growth led by private demand based on that 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.

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 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.

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 a unanimous vote, the text of "The Bank's View." It was confirmed that "The Bank's View" would be published on October 13, 2006 and the whole report on October 16, 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 September 7 and 8, 2006 for release on October 18, 2006.

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[7] The English version of the whole report was published on October 17, 2006.

Attachment

October 13, 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.