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December 22, 2006

Bank of Japan

Minutes of the Monetary Policy Meeting

on October 31, 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 Tuesday, October 31, 2006, from 9:00 a.m. to 12:44 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

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

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

¹ The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on December 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.

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. Shigyoh, Director, Secretariat of the Policy Board

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

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

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

I. Summary of Staff Reports on Economic and Financial Developments²

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 October 12 and 13, 2006.³ 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 increased somewhat and interest rates on Euroyen futures had been more or less unchanged. Long-term interest rates and Japanese stock prices had changed little since the previous meeting. The yen was being traded in the range of 117-120 yen to the U.S. dollar.

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, partly because 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, mainly reflecting tighter supply-demand conditions due to the economic expansion.

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, as both domestic and external demand were firm on the

² Reports were made based on information available at the time of the meeting.

³ The guideline was as follows:

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

whole.

In U.S. and European financial markets, long-term interest rates had been more or less unchanged and stock prices had risen. 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; real exports rose by 3.0 percent in the July-September quarter from the previous quarter. There seemed to have been no effects from the slowing of the U.S. economy to date.

In the corporate sector, profits had remained at high levels and business fixed investment had continued to increase.

As for the employment and income situation in the household sector, household income had continued rising moderately in a situation where various indicators continued to show tighter labor market conditions. Private consumption had been on an increasing trend. Many indicators related to private consumption, such as sales at department stores, had improved compared with the period until around July, when they were relatively sluggish, partly due to unfavorable weather. However, consumer spending as reported in the *Family Income and Expenditure Survey* declined.

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. While inventories as a whole had been more or less in balance with shipments, those of electronic parts and devices increased.

On the price front, 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 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, showing an increase of 0.2 percent in September. 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 (M₂+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 the economy was expanding moderately. They also agreed that economic activity had been generally in line with the projection in the April 2006 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), although so far developments in the corporate sector had been somewhat stronger than projected while those in the household sector had been somewhat weaker.

Members agreed that overseas economies taken as a whole continued to expand across a broader range of regions, although it had become clear that U.S. economic growth had slowed. With regard to the U.S. economy, most members said that real GDP growth slowed in the July-September quarter, mainly due to the decrease in housing investment, and commented that the scenario of a soft landing in which the deceleration in the economy would contain inflation pressures was becoming more likely to materialize. In relation to this, some members were of the view that thus far the adjustment in the housing market did not appear to have negatively affected private consumption. A few members said that the Chinese economy continued its high growth, although the rate of increase in fixed asset investment had been slowing somewhat. One member expressed the view that the recent decline in crude oil prices was likely to positively affect the oil-consuming economies. This member continued that the member would monitor future developments in global stock prices closely, as their recent rise might have a positive effect on the world economy.

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

As for domestic private demand, a few members said that, in the corporate sector, profits were high and fixed investment continued to increase. One of these members said that fixed investment was increasing in a growing number of firms, even nonmanufacturing firms and small firms. This member was of the view that at present there seemed to be no signs of overinvestment, since firms were still displaying a strong tendency to evaluate investment profitability carefully.

Members concurred that, in the household sector, household income had continued rising moderately in a situation where labor market conditions continued to tighten. Some members, however, referred to the fact that regular payments were relatively sluggish. Members agreed that private consumption had been on an increasing trend. Some members said that the pick-up in sales indicators, for example, in sales at department stores for September, suggested that the sluggishness in indicators related to private consumption in the period until around July was partly due to unfavorable weather. A few members commented, however, that the extent to which temporary factors had contributed to the recent sluggishness in those indicators warranted further examination.

Members shared the view that production had continued to be on an upward trend and inventories as a whole had been in balance with shipments. Regarding industrial production for September, some members noted the increase in inventories of electronic parts and devices and said that, although it seemed to have been partly due to temporary factors such as the upcoming introduction of new products using such parts and devices, future developments in these inventories warranted attention. One of these members said that the accumulation in inventories of electronic parts and devices was likely to exert downward pressure on industrial production in the immediate future.

Members agreed that the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) remained on a positive trend, but the pace of increase was moderate. Some members said that the fact that the preliminary figure for the year-on-year rate of change in the CPI (excluding fresh food) for October in the Tokyo metropolitan area became positive and was 0.1 percentage point higher than the previous month's rate of change suggested that there was no change in the positive trend in the year-on-year rate of change in the nationwide CPI. One member commented that the

increase in the CPI was seen in a broader range of regions. On the other hand, a few other members pointed out the possibility that, with the recent decline in crude oil prices, the positive contribution to the CPI of energy prices might become smaller. One of these members said that, looking at price movements in September by item, the number of items whose price change from a year earlier turned negative exceeded the number of items whose price change turned positive.

Meanwhile, one member said that it was confirmed in the October *Regional Economic Report* and reports at the meeting of general managers of the Bank's branches that all the regional economies were improving moderately, although there were differences in degree.

B. Financial Developments

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

Members concurred that financial markets were generally stable. However, a few members said that it was necessary to continue to pay attention to the impact of low interest rates in Japan on international financial markets.

C. Outlook for Economic Activity and Prices

With regard to the outlook for economic activity and prices, members agreed on the following assessment: from the second half of fiscal 2006 through fiscal 2007, Japan's economy was likely to experience a sustained period of expansion with domestic and external demand increasing and the positive influence of the strength in the corporate sector feeding through into the household sector.

Members noted the following as the background to this economic outlook. First, exports were likely to remain on the increase, as overseas economies as a whole were likely to keep expanding across a broader range of regions, although the pace of expansion in the U.S. economy had been decelerating recently. Second, the strong corporate performance was likely to continue. Third, the positive influence of the strength in the corporate sector was likely to continue to feed through into the household sector via channels such as increases in earned income and dividends. And fourth, the extremely accommodative financial conditions were likely to continue to support private demand.

Members agreed that as the economic expansion lengthened and matured, the growth rate was likely to slow gradually, approaching the potential growth rate. However, one member said that the economic expansion might mature later than expected and the growth rate for fiscal 2007 might be as high as for fiscal 2006. A few other members expressed the view that the rate of increase in wages might remain modest and as a result the positive influence of the strength in the corporate sector on the household sector might turn out to be weaker than expected. As factors supporting this view, they pointed out that firms generally were persisting in restraining labor costs and that the structural unemployment rate might have declined. A different member, on the other hand, mentioned the possibility that the structural unemployment rate might have increased due to the growing mismatch between supply and demand in the labor market brought about by technological innovation.

With regard to prices, members agreed that, given this economic outlook, the environment for prices would continue to improve, as the output gap was positive and was likely to widen at a moderate pace going forward and downward pressure from declining unit labor costs was likely to weaken. Members concurred that domestic corporate goods prices had exceeded the April projection, mainly reflecting rises in international commodity prices, and were likely to continue increasing, while the prices of crude oil and other commodities and foreign exchange rates would influence domestic corporate goods prices significantly. Members also agreed that the year-on-year rate of change in the CPI had been on a positive trend, generally in line with the April projection, and that the rate of increase was likely to rise gradually. In relation to the rebasing of the CPI from a 2000 to a 2005 base in August 2006, members agreed that the basic view on the CPI remained the same as that in the April projection, which was based on the 2000-base CPI.

With regard to upside and downside risks to the above outlook, members agreed that they could be summarized as follows: in relation to economic activity, (1) the growth path of the global economy, and (2) corporate investment activity; and in relation to the outlook for prices, (1) uncertainty regarding the sensitivity of prices to changes in the output gap, (2) developments in the prices of crude oil and other commodities, and (3) the impact from the change in the potential growth rate.

As for the growth path of the global economy, a few members said that attention should be paid to the risk that a greater-than-expected deceleration in U.S. economic growth

might not be offset by the growth of other economies. Some members pointed out that concern regarding inflation in the U.S. economy persisted. A few members said that given that the potential growth rate of the U.S. economy seemed to have declined, the possibility should be taken into consideration that the U.S. economy might grow at a slower pace in the remainder of 2006 and 2007 and might not regain the growth rate achieved before undergoing the adjustment even if the scenario of a soft landing materialized. A few members said that, although crude oil prices had regained stability compared to some time ago, developments in international commodity prices continued to require attention as there was still the risk that they might affect the global economy, including the U.S. economy, and international financial markets.

With regard to corporate investment activity, members agreed that it was important to mention, as in the April Outlook Report, that given the extremely accommodative financial conditions, firms might further accelerate investment based on optimistic projections of future profitability, and such acceleration might push up overall growth in the short run but later precipitate an economic slowdown.

Many members said that there was no need at present to be concerned about possible excessive rises in land prices, but developments in asset prices, including the effects of the accommodative financial environment, continued to warrant close monitoring. One of these members referred to the fact that there was an ongoing polarization of real estate prices between metropolitan and nonmetropolitan areas as well as within metropolitan areas. The member continued that, while an upturn in real estate prices might be more widely seen in the future, attention should also be paid to the medium- to long-term trend in real estate prices, considering such factors as Japan's relative position as a business location in Asia.

As for the outlook for prices, some members said that upward pressure on prices might be contained, as unit labor costs might start to increase later than expected given that the rate of increase in wages had been moderate. A different member noted that, if prices in China increased faster than anticipated, attention should be paid to the possible effects on price stability in Japan and other countries.

Regarding the conduct of monetary policy, members assessed economic activity and prices from the "two perspectives." Members first made an assessment in terms of the first perspective, that is to say, they made an assessment of the outlook they deemed most

likely for economic activity and prices through fiscal 2007 with reference to the view of market participants regarding the future course of the policy interest rate -- a view that was incorporated in market interest rates. Members agreed that Japan's economy was likely to achieve sustainable growth under price stability.

Members then made an assessment in terms of the second perspective, that is to say, they examined risks considered most relevant to the conduct of monetary policy, looking over a longer time horizon. Members agreed that attention should be paid to a risk in the medium to long term of larger economic swings, resulting in large fluctuations in the rate of inflation, as the stimulative effect of monetary policy on economic activity and prices might be amplified. Moreover, they agreed to note as a downside risk that economic expansion and rising prices might stall. In this regard, a few members said that the situation remained the same as in the assessment in the April Outlook Report: even if economic activity was less robust and the inflation rate lower than expected, the risk of the economy falling into a deflationary spiral seemed small, since the Japanese financial system had regained stability and the economy had cast off its 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 would adjust the level of interest rates gradually in the light of developments in economic activity and prices, while maintaining the accommodative financial conditions ensuing from very low interest rates for some time.

Some members expressed the view that, as market participants tended to pay keen attention to developments in individual indicators such as the CPI, the Bank should explain thoroughly that, in conducting monetary policy, it paid full attention to the underlying trend of 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 around 0.25 percent.

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 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) Market participants' attention had been focused on what projection for economic activity and prices the Bank would make in the October Outlook Report, whose text would be decided at the meeting, taking into account the effects, for example, of the rebasing of the CPI in August. In order to prevent financial markets from becoming unstable due to speculation regarding the future conduct of monetary policy, the government would like the Bank to clearly explain, based on the October Outlook Report, 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) 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) The government projected that the economic recovery supported by domestic private demand would continue, as resiliency in the corporate sector was extending into the household sector, and expected that the October Outlook Report would basically share this view. With regard to the upside and downside risks to the outlook for economic activity and prices, which were also pointed out in Outlook Reports, the government considered that key factors for the future course of Japan's economy would be how developments in crude oil prices affected the domestic and overseas economies and how wages changed, rather than an upside risk of business fixed investment accelerating. Therefore, it was of the view that particular attention should be paid to downside risks to the outlook for economic activity and prices.
- (3) 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." As for the future path of monetary policy, the Bank had stated that it would maintain the accommodative financial conditions ensuing from very low interest rates for some time. The government 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.

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 *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 a unanimous vote, the text of "The Bank's View."

It was confirmed that "The Bank's View" would be published on October 31, 2006 and the whole report on November 1, 2006.

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.

Attachment

October 31, 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.