Not to be released until 2:00 p.m. Japan Standard Time on Friday, December 22, 2006.

December 22, 2006

Bank of Japan

Minutes of the Monetary Policy Meeting

on November 15 and 16, 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 Wednesday, November 15, 2006, from 2:00 p.m. to 4:01 p.m., and on Thursday, November 16, from 9:00 a.m. to 12:20 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 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.

[2] Mr. K. Tanaka was present on November 16.

[3] Mr. E. Katsu was present on November 15.

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. Shigyoh, Director, Secretariat of the Policy Board

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

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

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

I. Summary of Staff Reports on Economic and Financial Developments[4]

A. Money Market Operations in the Intermeeting Period

The Bank conducted money market operations in accordance with the guideline decided at the previous meeting on October 31, 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 three-month instruments, such as financing bills (FBs) and Euroyen, had risen since the previous meeting. Interest rates on Euroyen futures had edged somewhat higher, particularly for those with nearby contract months.

Japanese stock prices had been more or less unchanged. The Nikkei 225 Stock Average was recently in the range of 16,000-16,500 yen.

Long-term interest rates had also been more or less unchanged, and were recently at around 1.7 percent.

The yen had been fluctuating against the U.S. dollar, partly reflecting releases of U.S. economic indicators. It was recently being traded in the range of 117.5-118.0 yen to the dollar.

C. Overseas Economic and Financial Developments

The U.S. economy continued to expand, but the pace of growth was decelerating. Housing investment continued to decrease and private consumption was decelerating moderately, while business fixed investment continued to increase. 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

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[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.

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. Private consumption, exports, and production remained on an uptrend. The NIEs and ASEAN economies continued to expand at a moderate pace, as both domestic and external demand were firm on the whole.

In U.S. financial markets, long-term interest rates and stock prices had been more or less unchanged, reflecting mixed developments in recently released economic indicators. In Europe, long-term interest rates had been more or less unchanged. Stock prices had risen slightly, partly due to favorable earnings reports released by some firms. In many emerging economies, financial markets generally remained firm, as evidenced by the continuing 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 generally been on an increasing trend, although the figure in the GDP statistics decreased in the July-September quarter. 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 in August and September, when the weather improved. As for services consumption, sales in the food service industry had been on a steady uptrend, and outlays for travel, especially overseas travel, had generally 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. Inventories as a whole had been more or less in balance with shipments. Although attention should be paid to developments in inventories of electronic parts, the upward trend in production was expected to continue as overseas economies continued to grow and domestic demand kept expanding. Anecdotal information suggested that production was likely to inch up in the October-December quarter.

With regard to 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 easing geopolitical risks, but they had recently been hovering at levels observed around the spring, partly due to cutbacks in production by OPEC. On the other hand, prices of nonferrous metals had remained high, albeit with some fluctuations. The pace of increase in domestic corporate goods prices had been slowing due to the drop in crude oil prices, and was expected to continue to slow in the immediate future, with the effects of the drop in crude oil prices remaining. 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 attitudes 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.

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 continued to expand moderately, generally in line with the Bank's projection presented in the October 2006 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), and 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 also agreed that so far mixed developments in recent economic indicators did not suggest that the Bank needed to change its assessment of the mechanisms underlying the economy made in the October Outlook Report, but members should watch future developments in economic activity and prices carefully.

Members concurred that the U.S. economy was likely to realize a soft landing, although the pace of growth was decelerating, and with the growth in Europe, Asia, and other regions, overseas economies taken as a whole continued to expand, with more economies gaining momentum, and were likely to keep expanding.

On the U.S. economy, members agreed that the pace of expansion was decelerating mainly due to the decrease in housing investment, but the deceleration was moderate on the whole, as seen in the fact that 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 concurred that the U.S. economy was likely to realize a soft landing and move toward sustainable growth partly supported by the decline in crude oil prices. Some members noted points that supported this view: there were signs that the decrease in housing investment was coming to a halt, and stock prices had risen. A few members commented that developments in Christmas sales were the key factor in the immediate future for further examination of the likelihood of a soft landing. As for prices, some members said that the risk that inflation might accelerate should continue to be watched closely, taking into consideration the continued rises in the core inflation rate and the increase in inflation pressures as a result of the decline in the unemployment rate and the rise in unit labor costs. These members said that there was a view that the potential growth rate of the U.S. economy had recently declined, and added that they would take this into account as they watched developments in inflation pressures with close attention.

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.

On East Asian economies, members concurred that both domestic and external demand continued to expand strongly in China. They also agreed that the NIEs and ASEAN economies on the whole continued to expand at a moderate pace although negative effects of the past rise in crude oil prices could be seen in some economic activity.

A few members said that, although crude oil prices had recently stopped declining after falling since August, close attention should continue to be paid to them since there were uncertainties that could cause them to move in either direction.

Regarding Japan's economy, members agreed that the increase in exports had continued, reflecting the expansion of overseas economies, and there seemed to have been no clearly discernible effects from the slowing of the U.S. economy to date. They also concurred that exports were likely to continue to increase.

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 said that the interim results of listed firms available at this point suggested that corporate profits remained strong. Members concurred that business fixed investment continued to increase and 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 the substantial decline in machinery orders in the July-September quarter was a reaction to the sharp increase in the April-June quarter, and was also attributable to a temporary factor, namely, a reduction in major telecommunications firms' cellular phone orders. A few of these members expressed the view that, even if those factors were excluded, the pace of increase in machinery orders might be decelerating. They said that it was therefore necessary to watch carefully whether the deceleration in machinery orders was consistent with the projection presented in the October Outlook Report, in which the growth rate of business fixed investment was expected to decline gradually in view of the capital stock cycle.

Members shared the view that private consumption had been on an increasing trend and was likely to continue to increase steadily, mainly reflecting the gradual increase in household income. Some members said that, although many sales indicators picked up after the weather improved in August, future developments in private consumption should be examined carefully since the growth in consumption had remained only modest in a situation where wages had not recorded a clear increase.

Many members commented that a substantial decrease in the figure for private consumption in the July-September quarter from the previous quarter in the first preliminary estimates of GDP was due to the following factors. First, the index of living expenditure in the *Family Income and Expenditure Survey*, which provided the basic information for calculating private consumption in the GDP statistics, posted a relatively sharp decline partly reflecting sampling factors. And second, unfavorable weather until around July had affected the figure. One member said that the underlying trend of private consumption was unlikely to decline since household income was rising, albeit moderately. Another member said that there might be structural factors exerting downward pressure on the underlying trend of consumption, and such factors might include the following. First, with the aging of the population, the growth in income might no longer lead directly to growth in consumption. And second, the elderly might be experiencing difficulty in liquidating their assets to obtain funds for consumption due to the low liquidity of residential property, which was the most important household asset. In response to this view, one member said that, although it was necessary to examine closely the effects of such possible structural factors on consumption behavior, their impact on short-term and cyclical developments in consumption was questionable.

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 the year-on-year rate of increase in inventories had recently exceeded that of shipments partly because of an unintended accumulation of inventories due to weaker-than-expected demand for cellular phones and new game consoles, and there was a risk that firms might have to adjust production in the immediate future. These members added that, so far, the risk of a production adjustment was limited to some products intended for the domestic market and any adjustment was unlikely to spread to a wider range of products, but developments in final demand worldwide such as Christmas sales in the U.S. economy warranted attention.

As for the employment and income situation, members concurred that household income had continued rising moderately in a situation where various indicators continued to show tighter labor market conditions. They also agreed that 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. One member said that the fact that there was no clear increase in wages despite the tightening of labor market conditions might merely be due to a time lag, but attention should continue to be paid to how firms' persistent stance of restraining labor costs would affect wages. A different member pointed out that compared to the past, strong corporate profits were less likely to lead to a rise in wages in Japan because the share of profits from overseas business operations had increased.

Some members said that the real GDP growth rate in the first preliminary estimates of GDP for the July-September quarter turned out to be higher than market expectations, but the figures were mixed: while net exports and business fixed investment increased, private consumption dropped significantly and the contribution from an increase in inventories was relatively large.

With regard to prices, members agreed that the pace of increase in domestic corporate goods prices had been slowing due to the drop in crude oil prices, and was likely to continue to slow in the immediate future, with the effects of the drop in crude oil prices remaining. One member said that prices were rising across a broader range of items, as evident in the fact that the share of items whose prices increased from a year earlier accounted for almost half of all the items selected to calculate the domestic corporate goods price index, marking the highest proportion since 2001.

Members concurred 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 this trend was likely to continue, as the output gap continued to be positive. A few members said that, although the statistical figures had been affected by the decline in crude oil prices and imputed rent, the underlying trend of the CPI was gradually rising. A different member expressed the view that while the rate of increase in the CPI would definitely rise gradually as a trend, there remained some uncertainty about the precise pace of its rise. With regard to factors that might affect the rate of change in the CPI in the immediate future, one member said that there were both negative and positive factors: 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 cellular telephone charges would have a positive effect. The member continued that, from a longer-term perspective, the member would pay close attention to the effects on prices of the continuing positive output gap, and to the pace at which the decline in unit labor costs decelerated.

As for developments in asset prices, one member expressed the view that the current recovery in demand for commercial and residential real estate was a natural consequence of the bottoming out of demand, and real estate investment was unlikely to overheat for the following reasons. First, financial institutions were becoming cautious about extending real estate loans. And second, there was little rush to purchase residential real estate despite the rise in interest rates, and price rises were being seen only in high-priced real estate.

B. Financial Developments

On the financial front, members reaffirmed their view that the financial environment remained accommodative as seen in the fact that the lending attitudes of private banks and the issuing conditions in capital markets were favorable. One member commented that the deceleration of growth in the amount outstanding of lending by private banks reflected the fact that firms were increasing credit demand mainly to obtain operating funds but were keeping fixed investment within cash flow. This member continued that the deceleration seemed to be consistent with the current moderate economic recovery.

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.

Some members noted that formation of interest rates in the money market had been stable, and expressed the view that this was against the backdrop of not only the Bank's flexible conduct of money market operations but also the increased efficiency and smoothness of funds transactions that had been achieved as market participants had become accustomed to trading in the current financial environment. A few of these members added that, as the restoration of the proper functioning of the money market progressed, market interest rates would be likely to reflect factors such as market participants' view of Japan's economy better, and this would contribute to more constructive communication of the Bank with market participants.

Regarding the future path of monetary policy, members agreed that they would continue to carefully assess economic activity and prices, and that if developments in economic activity and prices were likely to follow the Bank's projection presented in the October 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. One member said that, if it was confirmed with greater certainty at a future meeting that developments in economic activity and prices were following the Bank's projection presented in the October Outlook Report, the Bank should not hesitate to consider a policy change.

With regard to the fact that the timing of a possible policy change was increasingly attracting the attention of the public, including market participants, members agreed that the Bank should explain carefully that the timing of any policy change depended entirely on developments in economic activity and prices as it should not be thought that the timing was predetermined. Some members said that a divergence had emerged between market participants and the Bank on the view of the economic situation due partly to the release of some sluggish economic indicators. These members noted that the Bank should, in the process of assessing economic activity and prices, examine the divergence carefully, and that it should communicate with market participants more closely. A few members commented that it was important that the Bank utilize the new framework for the conduct of monetary policy introduced in March 2006 in communicating with the market, and that the Bank should make efforts to promote deeper understanding of the new framework among the public, including market participants.

IV. Remarks by Government Representatives

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

(1) Japan's economy continued to recover, as evidenced by the first preliminary estimate of real GDP growth rate for the July-September quarter, which showed an increase of 0.5 percent on a quarter-on-quarter basis. However, looking at growth by component, domestic demand edged up only by 0.1 percent and private consumption became

negative. Some other indicators released recently also showed weak developments.

(2) Prices were unlikely to decline continuously, but careful attention should continue to be paid to future price developments since factors such as the fall in crude oil prices could affect them.

(3) Given the current developments in economic activity and prices, the government considered that it was important that the Bank continue to firmly support the economy based on the Bank's current guideline for money market operations in order to achieve sustainable economic growth with price stability.

(4) The government would like the Bank to give due consideration to developments in financial markets. In order to prevent financial markets from becoming unstable due to speculation regarding the future conduct of monetary policy, it would also like the Bank to clearly explain, based on the Bank's decisions at previous meetings, 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. With regard to the upside and downside risks to the outlook for economic activity and prices, the government considered that particular attention should be paid to downside risks, since 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 upside risks. 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 to support the economy from the financial side responsibly, taking into account downside risks to the outlook for economic activity and prices.

(3) 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 November 16, 2006 and the whole report on November 17, 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 October 12 and 13, 2006 for release on November 21, 2006.

[6] The English version of the whole report was published on November 20, 2006.

Attachment

November 16, 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.