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May 22, 2007

Bank of Japan

Minutes of the Monetary Policy Meeting

on April 9 and 10, 2007

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

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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 Monday, April 9, 2007, from 2:00 p.m. to 4:36 p.m., and on Tuesday, April 10, from 9:00 a.m. to 12:41 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. A. Mizuno

Mr. K. G. Nishimura

Mr. T. Noda

Mr. S. Nakamura

Mr. H. Kamezaki

Government Representatives Present

Mr. K. Tanaka, Senior Vice Minister of Finance, Ministry of Finance²

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

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

¹ The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on May 16 and 17, 2007 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 April 10.

³ Mr. E. Katsu was present on April 9.

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. K. Shigyoh, Director, Secretariat of the Policy Board

Mr. K. Kamiyama, 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 March 19 and 20, 2007.⁵ The uncollateralized overnight call rate had generally been at around 0.5 percent, although it rose to 0.715 percent on March 30, the last business day of fiscal 2006.

B. Recent Developments in Financial Markets

In the money market, interest rates on Euroyen and on three-month financing bills (FBs) had been more or less unchanged. Interest rates on Euroyen futures, particularly those with distant contract months, had risen.

Japanese stock prices fluctuated, mainly in response to developments in U.S. stock prices, and rose later, mainly reflecting the depreciation of the yen against the U.S. dollar. The Nikkei 225 Stock Average was recently in the range of 17,500-18,000 yen.

Long-term interest rates had increased, mainly due to the rise in U.S. long-term interest rates, and were recently in the range of 1.65-1.70 percent.

The yen had depreciated against the U.S. dollar, mainly in response to the release of some U.S. economic indicators. It was recently being traded in the range of 118-120 yen to the dollar.

C. Overseas Economic and Financial Developments

The U.S. economy continued to expand, but the pace of growth was decelerating moderately. Business fixed investment as a whole seemed to be continuing on a gradual uptrend reflecting the high level of corporate profits, although machinery investment had recently been showing stronger signs of a slowdown. Meanwhile, housing investment continued to decrease. Private consumption had been relatively firm against the background of the continuing rise in household income, but had been on a decelerating trend. In this situation, the pace of increase in production and in the number of employees

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 0.5 percent.

was slowing moderately. As for prices, the consumer price index (CPI) for all items less food and energy, or the core CPI, continued to increase moderately, mainly reflecting tighter supply-demand conditions due to the economic expansion.

In the euro area, economic recovery continued to be solid, as the increase in production and improvement in corporate profits had led to recovery in business fixed investment and private consumption.

In China, both domestic and external demand continued to expand strongly. The rate of increase in fixed asset investment remained high, although it had slowed somewhat. Exports continued to show a substantial increase, and private consumption and production also remained on an uptrend. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole as domestic demand remained firm.

In financial markets, long-term interest rates and stock prices in the United States had risen but were still below levels before adjustments started in late February. In Europe, developments in long-term interest rates and stock prices had basically followed those in the United States. Long-term interest rates and stock prices in Europe, however, had almost returned to pre-adjustment levels, due mainly to the release of relatively strong economic and price indicators and expectations for restructuring in some industries. Stock prices in many emerging economies had risen, and in some economies, including China, stock prices had risen above their pre-adjustment levels.

D. Economic and Financial Developments in Japan

1. Economic developments

Exports as a whole had continued to increase against the background of the expansion of overseas economies, although those to the United States had weakened somewhat due to the economic slowdown there. Exports 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. The March *Tankan* (Short-Term Economic Survey of Enterprises in Japan) showed that business sentiment had been generally favorable and that business fixed investment plans for fiscal 2007 were relatively strong for the time of year, before the turn of the fiscal year in April.

Private consumption had been firm. Sales at department stores and supermarkets had been showing considerable improvement, assisted by favorable clearance sales and a good start to sales of spring apparel. Sales of electrical appliances had shown a clear increase recently. As for services consumption, sales in the food service industry had continued to trend upward, and outlays for travel, especially overseas travel, had been firm. Private consumption was expected to follow a gradual uptrend, mainly reflecting the gradual increase in household income.

Production had been on an increasing trend against the background of the growth in domestic and external demand. Production had continued to decrease marginally since January, largely in reaction to the high growth in the October-December quarter of 2006. Inventories had been more or less in balance with shipments in the industrial sector as a whole, although inventories of electronic parts and devices had remained at a high level. Production was likely to decrease marginally in the January-March quarter of 2007 but was considered to remain on an upward trend, reflecting the rise in domestic and external demand.

With regard to the employment and income situation, various indicators had continued to show tighter labor market conditions. Some sluggishness had recently been observed in wages. This was due to the fact that firms were still restraining labor costs, and might have also been attributable to the retirement of the baby-boomer generation, whose wage levels were relatively high. Household income had continued rising moderately, supported by the increase in the number of employees. 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, international commodity prices showed the following developments. Crude oil prices had recently been around the level of late December, having bounced back after dropping sharply through the beginning of 2007. Prices of nonferrous metals, particularly copper, fell through the beginning of the year, remaining nevertheless in high price ranges, but had recently rebounded. Compared with three-month-earlier levels, domestic corporate goods prices had recently been somewhat lower due to past declines in international commodity prices. They were expected to level off in the immediate future, as the decline in international commodity prices had come to a halt. The year-on-year rate of change in the CPI (excluding fresh food, on a nationwide

basis) had been around zero percent, mainly due to the past drop in crude oil prices. It was expected to continue to be around zero percent in the short run, with the effects of the drop in crude oil prices remaining. From a longer-term perspective, however, it was projected to continue to follow a positive trend, 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. The year-on-year rate of growth in the money stock (M_2 +CDs) was around 1.0 percent.

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 it continued to expand moderately, and was likely to experience a sustained period of growth as a virtuous circle of production, income, and spending was likely to remain intact.

Members agreed that overseas economies taken as a whole continued to expand, with more economies gaining momentum, and were likely to keep expanding.

Members concurred that the U.S. economy continued to expand, but the pace of growth was decelerating moderately with the continuing adjustments in the housing market. Many members said that, although the effect of the increase in delinquency rates for subprime mortgage loans was likely to be limited given the small size of the market, the risks associated with the adjustments in the overall housing market should continue to be watched carefully. Many members said that business fixed investment, particularly machinery investment, had been relatively weak recently, and therefore careful attention should be paid to future developments. On this point, a few members expressed the view that business fixed investment was unlikely to decline significantly given the fact that corporate profits remained at a high level. A few members said that the recent

deceleration of business fixed investment might be due partly to a decrease in firms' purchases of housing-related construction machinery, and also of trucks in response to new regulations on emissions of heavy trucks, which came fully into force in January 2007. One of these members added that a decrease in firms' expected growth rate might also be a factor behind the deceleration of business fixed investment. In view of the points made in the discussion, some members said that attention should be paid to the uncertainties faced by the U.S. economy. On the price front, many members said that inflation risk continued to warrant attention because growth in labor productivity was on a decelerating trend in a situation where labor market conditions were tightening. Based on these discussions, members concurred that both upside and downside risks should continue to be borne in mind, although the likelihood was considered to be high that the U.S. economy would realize a soft landing in which the economy would approach its potential growth rate in or after the middle of 2007.

With regard to European economies, many members said that economic recovery continued to be solid in the euro area, with domestic and external demand well in balance. On East Asian economies, many members expressed the view that in China both domestic and external demand continued to expand strongly. A few members noted, however, that attention should be paid to upside risks in the Chinese economy. Some members commented that the NIEs and ASEAN economies continued to expand at a moderate pace on the whole.

Regarding Japan's economy, members concurred that exports had continued to increase, reflecting the expansion of overseas economies, and were likely to continue to increase.

As for domestic private demand, members shared the view that business fixed investment continued to increase, and was likely to keep increasing, reflecting the ongoing growth in domestic and external demand and also the continuing high level of corporate profits. Many members said that the results of the March *Tankan* showed that business fixed investment plans for fiscal 2007 were relatively strong for the time of year, before the turn of the fiscal year in April. Many members commented that business sentiment had been favorable in the March *Tankan* even though the survey was conducted in a period when adjustment in the global financial market was ongoing. Moreover, some members expressed the view that, in addition to manufacturers, firms in nonmanufacturing industries

seemed to be gradually starting to lead the current economic growth, noting the following facts in relation to large nonmanufacturing firms. First, an increasing number of these firms were forecasting better business conditions. And second, large nonmanufacturing firms' fixed investment plans for fiscal 2007 showed relatively high growth. These members continued, however, that it remained unclear whether small nonmanufacturing firms would also start to lead economic growth.

Members agreed that private consumption had been firm and was likely to follow a gradual uptrend, mainly reflecting the gradual increase in household income. Many members said that indicators of private consumption, except for auto sales, had been favorable since January as seen, for example, in the fact that sales at department stores and supermarkets had shown an improving trend. One of these members noted that the *Family Income and Expenditure Survey* and the *Survey of Household Economy* confirmed that consumption was on a recovery trend not only in urban but also in rural areas. A few members said that the recent growth in consumption was partly due to temporary factors, such as the warm winter, which spurred sales of spring apparel.

Members expressed the view that production had remained on an increasing trend even though it had recently decreased marginally in reaction to the upsurge in the October-December quarter of 2006. They also said that production was likely to continue to be on an upward trend against the background of the rise in domestic and external demand.

Members concurred that inventories had been more or less in balance with shipments in the industrial sector as a whole, although inventories of electronic parts and devices had been at a high level relative to shipments. Some members expressed the view that, although global demand for IT-related goods remained firm and thus the risk that adjustment in inventories might become widespread seemed small, attention should continue to be paid to inventories of electronic parts and devices since the pace of increase in production capacity tended to be rapid in this sector. A few members commented that inventory adjustments of liquid crystal displays might be prolonged until around the summer.

As for the employment and income situation, members concurred that, in a situation where various indicators had continued to show tighter labor market conditions, household income had continued rising moderately, supported by the increase in the number

of employees. 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. With regard to nominal wages per worker, some members expressed the view that the recent slow growth might have been attributable to the increase in retirements in the baby-boomer generation, and possibly to a reduction in salaries of local government employees. One member said the following changes in firms' personnel systems might also be placing downward pressure on overall wages through a reduction in wages of personnel affected by those changes. First, firms were extending the retirement age. And second, a personnel system was being introduced under which managers were required to give up their position at a certain age but could continue to work at a nonmanagerial level. As for the outlook, some members saw the results of the March *Tankan* as suggesting that firms' feeling of a shortage of labor was steadily strengthening, and thus were of the view that upward pressure on wages was likely to increase moderately. They continued that a private institution's survey showed that wage increases were likely to be higher in fiscal 2007 than in fiscal 2006. A different member added that attention should continue to be paid to the possibility that the declining trend in productivity of small nonmanufacturing firms might exert downward pressure on overall nominal wages.

Members concurred that the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) was likely to be around zero percent in the short run, with the effects of the drop in crude oil prices remaining, but from a longer-term perspective it was likely to continue to follow a positive trend as the output gap continued to be positive.

Many members said that the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) for March was likely to be slightly below zero percent for the second consecutive month, due mainly to the effects of the past drop in crude oil prices and the introduction of low-cost billing plans for cellular phones. One member added that the meaning of the expression "around zero percent" in the *Monthly Report of Recent Economic and Financial Developments* included situations where the year-on-year rate of change in the CPI was slightly below zero percent. Some members commented that, in examining future developments in the CPI, the effects of the revision of services prices to be made in and after April should be closely monitored. A few members said that upward pressures on the CPI were likely to increase gradually, because the utilization of resources

was likely to be on an increasing trend, as suggested by the diffusion indices for employment conditions and production capacity in the March *Tankan*. A different member said that international commodity prices had bounced back recently, and such upward pressures on upstream prices warranted attention because they might affect consumer prices eventually.

Regarding asset prices, many members commented that both residential and commercial land prices had risen for the first time in 16 years according to the data in *Land Price Publication*. Some of these members said that land prices rose in urban areas, including major nonmetropolitan cities, while they continued to decline in most other areas. Some members commented that active buying and selling of real estate and large increases in land prices had been observed in some parts of metropolitan areas. Based on the above discussion, many members expressed the view that, although taken as a whole the formation of land prices was generally consistent with the expected return, attention should continue to be paid to developments in asset prices and their effects on economic activity.

B. Financial Developments

On the financial front, some members said that adjustments observed in financial markets worldwide since late February did not seem to suggest a change in the fundamentals of the global economy, because they seemed to have been caused by market participants who had been somewhat excessively taking on risk but had modified their behavior in response to the plunge in the Chinese stock market and to some negative indicators in the U.S. economy. These members added that developments in financial markets continued to warrant close attention since it was too early at this point to say with certainty that financial markets had completely emerged from an adjustment phase.

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 0.5 percent. Members also concurred that it would be appropriate to keep their basic thinking on the future course of monetary policy unchanged.

As for developments in the money market, many members said that the Bank had managed the uncollateralized overnight call rate well on the whole at around 0.5 percent, albeit with a rise in the rate on March 30, the last business day of fiscal 2006. A few members expressed the view that the rise was partly due to the fact that some financial institutions had taken a cautious stance on extending credit, factoring in the implementation of the revised international capital framework (Basel II). A few members, noting that use of the complementary lending facility increased on the last business day of fiscal 2006, said that there was no significant disruption in the money market partly due to the effective functioning of the facility. Meanwhile, a few other members said that the Bank should examine closely how the complementary lending facility influenced the behavior of financial institutions and the functioning of the money market. Based on these discussions, some members expressed the view that developments in the money market on the last business day of fiscal 2006 would be referred to in future discussions concerning the improvement of the functioning of the money market and the level of the basic loan rate applied to complementary lending.

Some members said that the financial environment remained accommodative even after the policy change in February as was confirmed, for example, by the financial positions of firms and the lending attitudes of financial institutions as perceived by firms in the March *Tankan*.

Regarding the Bank's communication with market participants, many members agreed again that, under the system in which decisions were made by votes after thorough discussion among the Policy Board members, the information that the Bank should provide was its assessment of economic activity and prices and its basic thinking concerning the conduct of monetary policy. One of these members expressed the view that, since the policy change in February, market participants seemed to be coming to understand better the Bank's assessment of economic activity and prices and its basic thinking about the conduct of monetary policy. Meanwhile, one member said that the Bank should provide information giving due consideration to the enhancement of the predictability of monetary policy.

Based on the above discussion, members agreed that after discussing its views thoroughly and formulating them, the Bank should explain clearly in the April 2007 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) the outlook for

economic activity and prices and its risk assessment, and the basic thinking based on them concerning the conduct of monetary policy, and that the Bank should continue such efforts so as to promote deeper understanding among market participants and the public of its framework for the conduct of monetary policy. They also agreed that the Bank would present in the April 2007 Outlook Report the results of the review of its "understanding of medium- to long-term price stability," which was to be, in principle, reviewed annually.

IV. Remarks by Government Representatives

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

- (1) Japan's economy continued to recover but should continue to be watched closely as there were weak developments in, for example, wages, and business sentiment seemed somewhat cautious.
- (2) The year-on-year rate of change in the CPI had turned negative for the first time since April 2006, and therefore whether upward pressure on prices would develop required careful monitoring.
- (3) Given the current developments in economic activity and prices, the government would like the Bank to continue to support the economy from the financial side based on the Bank's current guideline for money market operations so as to ensure the sustainability of the ongoing economic recovery.
- (4) The government would like the Bank to give due consideration to overall financial market developments. In order to prevent financial markets from becoming unstable due to speculation regarding the future conduct of monetary policy, the government would also like the Bank to clearly explain its assessment of economic activity and prices and 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) The government considered that Japan's economy continued to recover, but as it had repeatedly stated, the positive influence of the strength in the corporate sector on the household sector had recently weakened somewhat and a comprehensive review of developments in prices suggested that the economy had not yet overcome deflation.
- (2) With regard 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 overseas economies affected the domestic economy and how the positive influence of the strength in the corporate sector fed through into the household sector, rather than upside risks.

- (3) In order to achieve sustainable economic growth led by private demand based on price stability, it was important for the government and the Bank to make joint efforts, with a shared basic perspective on macroeconomic management. The government would like to request 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 firmly support the economy from the financial side in a responsible manner by maintaining the accommodative financial conditions ensuing from very low interest rates, taking into account downside risks to the outlook for economic activity and prices.
- (4) The Bank's outlook for economic activity and prices for two years ahead through fiscal 2008 and the future course of monetary policy would be presented in the April 2007 Outlook Report after being discussed at the next Monetary Policy Meeting on April 27, 2007. The government was pursuing enhancement of the economy's growth capacity with the hope of achieving in the next five years a nominal GDP growth rate of around 3.5 percent or higher and a real GDP growth rate of around 2 percent or substantially higher, as presented in the "Direction and Strategy for the Japanese Economy." The government therefore hoped that the Bank would firmly support these efforts from the financial side. The government would also like the Bank to fulfill its accountability to the public by explaining its view regarding the economy's path toward price stability. The government was aware that the Bank would conduct its annual review of the "understanding of medium- to long-term price stability" at the next meeting. At the January meeting of the Council on Economic and Fiscal Policy, the opinion was expressed that the Bank should carry out the review from the perspective of how to dispel deflationary concern among market participants and how to secure transparency and fulfill its accountability to the public. The government hoped that the "understanding of medium- to long-term price stability" would be expressed in a way that suggested clearly the future course of monetary policy in order to ensure price stability.

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 0.5 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 0.5 percent.

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

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 April 10, 2007 and the whole report on April 11, 2007.⁶

⁶ The English version of the whole report was published on April 12, 2007.

Attachment

April 10, 2007

Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by a unanimous vote,^[Note] 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 0.5 percent.

^[Note] Voting for the action: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. A. Mizuno, Mr. K. G. Nishimura, Mr. T. Noda, Mr. S. Nakamura, and Mr. H. Kamezaki.
Voting against the action: None.