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June 20, 2007

Bank of Japan

Minutes of the Monetary Policy Meeting

on April 27, 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 Friday, April 27, 2007, from 9:00 a.m. to 2:03 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 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 June 14 and 15, 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.

Mr. T. Idesawa, Director-General, International Department

Secretariat of the Monetary Policy Meeting

Mr. K. Osugi, Director-General, Secretariat of the Policy Board

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

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

Mr. S. Yamaguchi, 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 April 9 and 10, 2007.³ The uncollateralized overnight call rate had been at around 0.5 percent.

B. Recent Developments in Financial Markets

In the money market, interest rates on term instruments, particularly those with longer maturities, had increased somewhat, and those on Euroyen futures had risen slightly. Long-term interest rates and Japanese stock prices had been more or less unchanged. The yen had generally been 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. Housing investment continued to decrease. Private consumption had been relatively firm against the background of the continuing rise in real disposable income, but had been on a decelerating trend. Business fixed investment as a whole remained on a gradual uptrend, although investment in equipment had recently been showing clear signs of a slowdown. As for prices, the rate of increase in the consumer price index (CPI) for all items had risen, reflecting higher energy prices. The core CPI (the CPI for all items less food and energy) remained on a moderate upward trend.

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. The U.K. economy continued to show relatively high growth.

As for East Asian economies, in China, both domestic and external demand continued to expand strongly. The rate of increase in fixed asset investment remained high, and exports had remained on a strong uptrend. The year-on-year rate of increase in

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 0.5 percent.

consumer prices had risen due to higher food prices. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole as domestic demand remained firm.

In financial markets, stock prices in the United States had risen due mainly to favorable corporate results, returning to the level before the adjustment at the end of February. Stock prices in Europe and many emerging economies had been on an upward trend.

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. Real exports increased by 3.0 percent in the January-March quarter from the previous quarter. Exports were expected to continue to rise as overseas economies taken as a whole continued to expand.

In the corporate sector, profits had remained high and business fixed investment had continued to increase. As for machinery orders, a leading indicator of machinery investment, the average for January and February was higher than that for the months in the October-December quarter, which was also higher than in the previous quarter.

With regard to the household sector, in a situation where labor market conditions had been tightening, household income had continued rising moderately, supported by the increase in the number of employees. Under these circumstances, private consumption had been firm. Sales at department stores and some other indicators relating to private consumption decreased in March due to the return of cold weather, but in terms of the average for the months in the January-March quarter, many consumption indicators increased from the previous quarter.

Production had been on an increasing trend against the background of the growth in domestic and external demand. Although it decreased marginally in the January-March quarter from the October-December quarter, the decline was largely due to a reaction to the high growth in the previous quarter and production was likely to remain on an upward trend. 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.

On the price front, compared with three-month-earlier levels, the domestic

corporate goods price index (CGPI) stayed about the same as the decline in international commodity prices had come to a halt. It was expected to start increasing, since international commodity prices had been rising again recently. The year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) was minus 0.3 percent in March, mainly due to the drop in crude oil prices. It was likely to continue to be around 0 percent in the short run, although this would depend on developments in the price of crude oil. From a longer-term perspective, however, the rate of change in the CPI 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 above 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.

Members agreed that overseas economies taken as a whole continued to expand with momentum being gained across a wide range of economies, although it was becoming clear that the U.S. economy was decelerating. With regard to the U.S. economy, many members said that close attention should be paid to the adjustments in the housing market, which were still ongoing. A few members noted, however, that there had been no sign of the increase in delinquency rates for subprime mortgage loans affecting the overall economy. Meanwhile, one member commented that although private consumption had been firm recently, the pace of growth might decelerate in the future as the consumer confidence index had declined substantially. Some members said that business fixed investment, which had

been relatively weak recently, should also be watched carefully. On the price front, many members noted that there was a risk of inflation remaining at a high level mainly due to the tightening of labor market conditions. Given these developments in the U.S. economy, members concurred that although it would be appropriate to maintain the main scenario, in which the economy was heading for a soft landing, both upside and downside risks continued to warrant attention. Regarding the Chinese economy, some members noted that the pace of growth in real GDP had been high and there was a risk of the economy overheating.

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

As for domestic private demand, members concurred that, in the corporate sector, high profits had been maintained and business fixed investment had continued to increase.

With regard to the household sector, members agreed that as labor market conditions had been tightening, household income had been trending upward, albeit moderately. Many members said, however, that nominal wages per worker, which had been sluggish recently, should be watched carefully. One of these members added that improvement in business conditions was lagging behind in certain industries and for firms of a certain size, and this might be one of the factors constraining wage growth. A different member pointed out that wages per working hour were increasing, albeit only to a small extent. As for private consumption, many members expressed the view that it had been firm, with some fluctuations.

Members concurred that production had remained on an increasing trend although it was relatively weak in the January-March quarter partly due to production adjustment in some industries in reaction to the high growth in the previous quarter. Some members said that recent developments in production had been somewhat weaker than expected, and one of these members commented that attention should be paid to the risk that adjustments in production might continue for a while longer. Members agreed 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 remained at a high level.

Members concurred that the year-on-year rate of change in the CPI (excluding fresh food) continued to be around 0 percent, partly reflecting the continuing effects of the drop in crude oil prices. One member said that the 0.3 percent decline in the CPI in March

seemed to be due partly to a temporary increase in the negative contribution of falls in airfares and to the reduction in mobile telephone charges. A different member commented that rounding in the process of calculating the index might have contributed to the larger year-on-year rate of decline in the CPI for March.

Meanwhile, a few members said that it was confirmed in the reports at the April 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. One member, noting that stock prices in major economies in North America and Europe had recovered to the levels before the adjustment at the end of February, said that the pace of recovery in Japanese stock prices had been somewhat slow relative to that of other major economies, and that this seemed to be attributable to investors' concern about future business performance and their cautiousness about the potential risk of an appreciation of the yen. A different member said that although the foreign exchange market had recently been stable, attention should continue to be paid to market developments, including those in yen carry trades.

C. Outlook for Economic Activity and Prices

With regard to the outlook for economic activity and prices, members agreed on the following assessment: from fiscal 2007 through fiscal 2008, Japan's economy was likely to continue its sustained expansion with a virtuous circle of production, income, and spending in place.

Members noted the following as the background to this economic outlook. First, exports were likely to remain on the increase, as overseas economies taken as a whole were expected to keep expanding with momentum being gained across a wide range of economies, although the pace of growth in the U.S. economy had recently been decelerating. Second, strong corporate performance was likely to continue. Third, it was expected that the positive influence of the strength in the corporate sector would continue to feed through

into the household sector slowly but steadily. And fourth, the extremely accommodative financial conditions were likely to continue to support private demand.

Members were of the view that the year-on-year rate of growth in real GDP was likely to register around 2 percent, somewhat higher than the potential growth rate, for both fiscal 2007 and fiscal 2008. One member added that assuming that the accommodative financial conditions were maintained, there was a possibility that the year-on-year rate of growth in real GDP in and after fiscal 2007 might be slightly higher than in recent years.

With regard to prices, members agreed that, given this economic outlook, the environment surrounding prices was likely to improve gradually, as estimates of the output gap suggested that supply and demand conditions would continue to tighten and downward pressure from declining unit labor costs was likely to weaken. Members concurred that the domestic CGPI had recently been somewhat lower than the previous projection in October, reflecting declines in international commodity prices, but, as for the outlook, it was likely to maintain its upward trend, although this would be subject to future developments in prices of crude oil and other commodities as well as foreign exchange rates. Members agreed that movements in the CPI (excluding fresh food) were currently somewhat weaker than previously projected, mainly due to the fall in crude oil prices. They also concurred that going forward, the year-on-year rate of change in the CPI was likely to be around 0 percent in the short run, depending on developments in crude oil prices, but was likely to rise gradually in the longer run. One member said, however, that the year-on-year rate of change in the CPI might remain slightly below 0 percent for a while, and the risk that consumer prices might not rise smoothly warranted close attention.

Members raised the following upside and downside risks to the above outlook: in relation to economic activity, (1) developments in the global economy, (2) supply and demand conditions for IT-related goods, and (3) possible larger swings in financial and economic activity based on optimistic assumptions regarding, for example, financial conditions; and in relation to the outlook for prices, (1) uncertainty regarding the sensitivity of prices to changes in the output gap and (2) developments in the prices of crude oil and other commodities.

As for developments in the global economy, members concurred that there was a risk that U.S. economic growth might decelerate more than expected due to longer housing market adjustments and weaker business fixed investment than had been projected. Some

members expressed the view that if this situation materialized, other economies might also be adversely affected. A different member said that, even if the U.S. economy decelerated more than expected, the global economy taken as a whole would not be harmed seriously as European and Asian economies were strong on the whole. Many members noted that concern regarding inflation in the U.S. economy had persisted. One of these members said that the possibility of stagflation, the risk of economic deceleration and inflation materializing simultaneously, could not be ruled out. Many members noted that there were upside risks in the Chinese economy. A few members said that developments in international commodity prices, such as crude oil prices, continued to require close monitoring, as there was a risk that they might have an impact on the global economy and international financial markets.

With regard to supply and demand conditions for IT-related goods, some members expressed the view that, although inventories of electronic parts and devices had remained at a high level and thus production adjustment was likely to continue, these developments had not been widespread so far and demand for IT-related goods, on a global basis, remained steady. These members said, however, that attention should be paid to the risk of a serious deterioration in supply and demand conditions triggered by, for instance, a deceleration in the global economy, since the pace of increase in the global supply of IT-related goods had been rapid.

As for the effects of the accommodative financial environment, members were of the view that Japan's current economic circumstances were such as potentially to encourage assertive financial and economic activity, with the financial positions of both firms and financial institutions improving and real interest rates remaining very low. Members also agreed that in this situation, if greater assertiveness should be based on optimistic assumptions regarding future profitability, the result could well be a misallocation of resources in the long run as agents became over-extended in financial markets or poured funds and other resources into inefficient economic activities. One member, referring to the upturn in land prices in *Land Price Publication* and the buoyancy in the real estate investment trust (REIT) market, said that there was no need at present to be concerned about possible excessive rises in land prices, but developments in asset prices continued to warrant close monitoring, since the real estate market seemed to be somewhat overheated in certain areas.

With regard to the outlook for prices, members were of the view that it was uncertain whether prices were more sensitive or less than the Bank's assumption to changes in the output gap. Some members commented that there was a possibility that prices would turn out to be weaker than the projection, since firms had remained cautious about raising wages and prices. A few other members said that the potential growth rate might be higher than had been assumed and the size of the labor force might increase more than expected, and if this turned out to be the case, growth in wages and prices might deviate downward from the projection. On the other hand, one member said that a closer look at recent developments surrounding prices suggested that wages for workers with specialized skills and costs such as commercial rents had been on an upward trend, and thus due attention should also be paid to upside risks to the outlook for prices. Members agreed that considerable uncertainty surrounded developments in the prices of crude oil and other commodities, leaving the potential for movement in either direction.

One member, citing Japan's situation where prices, especially services prices, and wages tended not to rise, said that it might be an option to stabilize inflation expectations of firms and households by conducting monetary policy based on a framework that made it easy for them to form an idea of future price levels. In response, a different member commented that people's views with regard to prices and the economic structure were formed fundamentally based on their past experiences, and therefore it might cause confusion if a hasty attempt was made to affect them by means of monetary policy.

Members assessed economic activity and prices from the "two perspectives" taking into account the above outlook and upside and downside risks. They first made an assessment in terms of the first perspective, that is to say, they assessed the most likely outlook for economic activity and prices through fiscal 2008 with reference to the view of market participants regarding the future course of the policy interest rate -- a view that is incorporated in market interest rates. They agreed that Japan's economy was likely to continue its sustained expansion with a virtuous circle of production, income, and spending in place.

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, extending the time horizon. They concurred that attention should be paid to a medium- to long-term risk of larger swings in economic activity and prices and of inefficient allocation

of resources as the stimulative effect of monetary policy might be further amplified. It was also agreed that, if the downside risks mentioned earlier should materialize, the improvement in the economic situation might stall or prices might continue not to rise despite an improvement in economic conditions.

With regard to the future conduct of monetary policy, as a result of the assessment of economic activity and prices described above, members agreed that it would be appropriate to keep their basic thinking on the future conduct of monetary policy unchanged: while confirming that Japan's economy remained likely to follow a path of sustainable growth under price stability in light of the "understanding of medium- to long-term price stability" and assessing relevant risk factors, the Bank would adjust the level of interest rates gradually in accordance with improvements in the economic and price situation.

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.

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 wages and in production of, for example, electronic parts and devices.
- (2) In view of the fact that the year-on-year rate of change in the CPI remained negative, price conditions required careful monitoring to see whether upward pressure on prices developed.
- (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) Market participants were focusing on the April 2007 *Outlook for Economic Activity and*

Prices, whose text would be decided at the meeting, because it would include the Bank's projection for economic activity and prices in fiscal 2008 and the results of its first review of the "understanding of medium- to long-term price stability" since its original release in March 2006. 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 on the future conduct of monetary policy to market participants and the public.

The representative from the Cabinet Office made the following remarks.

- (1) Japan's economy continued to recover, despite weakness in production in some sectors. 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 rather than upside risks, since one of the key factors for the future course of Japan's economy would be the effects of developments in overseas economies.
- (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 giving 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 government was pursuing strengthening of the economy's growth potential 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. At meetings of the Council on Economic and Fiscal Policy, the "understanding of medium- to long-term price stability" had been taken up from the perspective of dispelling deflationary concern among market participants. The government would like the Bank to explain clearly its thinking on 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. Review of the "Understanding of Medium- to Long-Term Price Stability"

In March 2006, the Bank announced, in the publication of "The Bank's Thinking on Price Stability," that the "understanding of medium- to long-term price stability" (the level of inflation that each member of the Policy Board understood, when conducting monetary policy, as being consistent with price stability over the medium to long term, hereafter "understanding") would be, in principle, reviewed annually. Since about a year had passed since this announcement, a review was conducted at this meeting.

Members reaffirmed the basic thinking on price stability and concurred that it was

appropriate to maintain the current thinking that price stability was a state where various economic agents including households and firms could make decisions regarding such economic activities as consumption and investment without being concerned about fluctuations in the general price level. They also agreed that, given factors such as the considerable time the effects of monetary policy took to work through the economy, the Bank should forecast developments in economic activity and prices from a sufficiently long-term viewpoint and strive to realize price stability over the medium to long term. Some members said that this forward-looking approach to achieving price stability was very important for the conduct of monetary policy, but it had not yet been fully understood by the public. These members were therefore of the view that the Bank should continue to explain it at every opportunity.

With regard to points that should be discussed in examining the "understanding," one member commented that discussion should be based on a price index which the public at large was accustomed to, and therefore, in the case of Japan, it was appropriate to continue to use the CPI. As for measurement bias in the CPI, some members said that it seemed to remain insignificant even after taking account of last year's rebasing of the index. In relation to the "safety margin" that acted as a buffer against the risk of falling into a vicious circle of declining prices and deteriorating economic activity, some members said that the risk seemed to be small, since the strength of the corporate sector and of the financial system had been enhanced, the potential growth rate seemed to have increased, and the degree of downward rigidity of wages seemed to be sufficiently small. With regard to the level of inflation perceived by households and firms as consistent with price stability, many members expressed the view that it had remained low and stable.

Based on the above considerations, members exchanged views regarding the specific figures that would represent the "understanding" in terms of the year-on-year rate of change in the CPI. Figures presented by many members were centered around 1 percent, with ranges of approximately 0.5 to 1 percentage point in either direction attached; some of these members added that their median figures were slightly below 1 percent. There was one member who expressed the member's "understanding" as a range approximately from 1 to 2 percent. A different member said that the member's range lay between 0.5 and 1 percent, and another member said that the member's median figure was a positive number closer to 0 percent than to 1 percent. After stating their individual views,

members agreed, as on the previous occasion a year ago, that they could be summarized as follows: the "understanding," expressed in terms of the year-on-year rate of change in the CPI, took the form of a range approximately between 0 and 2 percent, with most members' median figures falling on one side or the other of 1 percent.

VII. 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 April 27, 2007 and the whole report on May 1, 2007.

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.

VIII. Approval of the Minutes of the Monetary Policy Meeting

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of March 19 and 20, 2007 for release on May 7, 2007.

Attachment

April 27, 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.