Not to be released until 8:50 a.m. Japan Standard Time on Wednesday, June 20, 2007.

June 20, 2007

Bank of Japan

Minutes of the Monetary Policy Meeting
on May 16 and 17, 2007

(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, May 16, 2007, from 2:00 p.m. to 4:30 p.m., and on Thursday, May 17, from 9:00 a.m. to 12:37 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[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, Deputy Director-General, 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 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.

[2] Mr. K. Tanaka was present on May 17.

[3] Mr. E. Katsu was present on May 16.

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. K. Osugi, 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. N. Takeda, 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 April 27, 2007.[5] The uncollateralized overnight call rate had been at around 0.5 percent. The stability of the overnight call rate seemed to have been mainly due to the fact that market participants had become accustomed to the current financial environment and that, from April 16, 2007, the Bank had moved forward the timing of the release of the daily projection of reserve balances.

B. Recent Developments in Financial Markets

In the money market, interest rates on term instruments, such as yields on financing bills (FBs) and treasury bills (TBs) and Euroyen rates, and interest rates on Euroyen futures had been more or less unchanged.

Japanese stock prices had been more or less unchanged, although they had fluctuated somewhat reflecting developments in stock prices overseas. The Nikkei 225 Stock Average was recently at around 17,500 yen.

Long-term interest rates had been more or less unchanged, and were recently at around 1.65 percent.

The yen had been more or less unchanged against the U.S. dollar, and was recently being traded in the range of 119-121 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. Business fixed investment as a whole remained on a gradual uptrend, reflecting the increase in investment in IT-related equipment and the steady growth in investment in structures, although investment in non-IT-related equipment had recently been showing clear signs of a slowdown. Private consumption had been relatively firm against the background of the continuing rise in

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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 0.5 percent.

household income. In this situation, the pace of increase in production and in the number of employees was slowing moderately on the whole. As for prices, the consumer price index (CPI) for all items had been rising, reflecting higher energy prices. The year-on-year rate of increase in the core CPI (the CPI for all items less food and energy) remained elevated.

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 also continued to show relatively high growth.

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. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole as exports had been regaining momentum and domestic demand remained firm.

In financial markets, long-term interest rates in the United States had been more or less unchanged, reflecting mixed developments in economic and price indicators. Stock prices there rose reflecting stronger-than-expected corporate results and large-scale mergers and acquisitions, but subsequently fell due to the release of some weaker-than-expected economic indicators. In Europe, while long-term interest rates had been more or less unchanged, stock prices had declined marginally after rising. Stock prices in many emerging economies had risen.

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. Machinery orders, a leading indicator of machinery investment, had recently stayed at a high level, albeit with large fluctuations. Business fixed investment was expected to keep increasing since the growth in domestic and external demand and the high level of corporate profits were likely to be maintained.

Private consumption had been firm. Sales at department stores and supermarkets, particularly of apparel, had continued to be susceptible to weather conditions, but in terms of the average for the months in the January-March quarter, they were firm. Sales of electrical appliances had been on an uptrend, reflecting strong sales of digital appliances, such as flat-panel televisions, and of new game consoles. As for services consumption, sales in the food service industry had continued to trend upward and outlays for travel, especially overseas travel, had generally 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. It decreased in the January-March quarter, but the decline was largely due to a reaction to the high growth in the previous quarter. 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 elevated relative to shipments. Production was likely to remain on an upward trend, reflecting the rise in domestic and external demand. Interviews with firms also suggested that production was likely to increase again in the April-June quarter.

As for employment and income, 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. 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 had remained at high levels, albeit with some fluctuations, as global demand continued to trend upward. The three-month rate of change in the domestic corporate goods price index (CGPI) had turned positive, mainly due to the rebound in international commodity prices, and the CGPI was expected to continue increasing in the immediate future. The year-on-year rate of change in the CPI (excluding fresh food) was minus 0.3 percent in March mainly due to declines in airfares and mobile telephone charges in addition to a slightly increased negative contribution from petroleum products. It was expected to continue to be around 0 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 at around 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 the first preliminary estimate of real GDP growth rate for the January-March quarter turned out to be broadly in line with the Bank's projection, staying at a level higher than the current potential growth rate, which was estimated to be around 1.5 percent or somewhat higher. One member noted that the contribution of domestic demand to the growth rate decreased partly due to a reaction to high growth in the October-December quarter, while that of external demand increased significantly.

Members agreed that overseas economies taken as a whole continued to expand with momentum being gained across a wide range of economies, and were likely to keep expanding. One member commented that the deceleration in the U.S. economy had been fully offset by growth in other economies.

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. With regard to the substantial deceleration in the real GDP growth in the January-March quarter, many members expressed the view that, although external demand declined, domestic demand was relatively solid as seen in the fact that private consumption was relatively firm and business fixed investment as a whole remained on a gradual uptrend.

As for the outlook, members agreed that the scenario in which the U.S. economy would realize a soft landing after adjustments in household spending abated in the second half of 2007 remained likely to materialize. Many members were of the view, however, that both upside and downside risks continued to warrant attention, mainly due to the following factors. First, the negative effects of developments in the subprime mortgage market had been limited to date, but the risk of adjustments in the housing market persisting for longer than expected was still not negligible. Second, the slowdown in the increase in employment and the rise in gasoline prices might depress households' real disposable income, and thus lead to a deceleration in consumption growth. Third, business fixed investment might remain weak for some time, as investment in non-IT-related equipment had been showing clear signs of a slowdown. And fourth, the tightening of labor market conditions persisted, keeping the inflation rate elevated.

With regard to European economies, members agreed that economic recovery in the euro area 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, and that the U.K. economy also continued to show relatively high growth. On East Asian economies, members concurred that in China both domestic and external demand continued to expand strongly, and 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. One member said that exports as a whole had continued to be on an uptrend, although those to the United States, especially automobile-related goods and construction machinery, had been negatively affected by the economic slowdown there. A different member added that Japan's economy had become less dependent on the U.S. economy, and exports were therefore likely to remain firm supported by growth in other economies.

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 expressed the view that business fixed investment was likely to keep increasing due to the following factors. First, firms' profit opportunities had been increasing against the background of progress in economic globalization. Second, firms were replacing obsolete equipment, taking advantage of their high profits. And third, the accommodative financial conditions seemed to be encouraging firms to take a positive attitude toward investment. One of these members referred to the results of the *Annual Survey of Corporate Behavior (Fiscal 2006)* conducted by the Cabinet Office, which showed that firms expected business fixed investment to increase by more than 5 percent annually on average for the next three years. Many members said that a significant drop in firms' forecasts of machinery orders for the April-June quarter did not need to be taken as a sign of deceleration in machinery investment because, in the past few years, while firms' forecasts for the April-June quarter made at the beginning of the fiscal year tended to be low, actual machinery orders generally turned out to have increased. One of these members was of the view that, against the background of the extremely high levels of unfilled machinery orders, some deceleration in machinery orders was in fact consistent with the Bank's projection of a gradual deceleration in business fixed investment through fiscal 2008. A few other members added that close attention should be paid to developments in business fixed investment data, because there were matters of concern such as the fact that actual machinery orders had recently been low compared with the levels forecasted by firms.

Members concurred that private consumption had been firm and was likely to follow a gradual uptrend, mainly reflecting the gradual increase in household income. Some members commented that it had become clearer that private consumption was improving as seen in the fact that consumption of nondurable and semi-durable goods, which had for some time been somewhat weaker than that of durable goods and services, had shown firmness, albeit with some fluctuations.

Members agreed that production had been on an increasing trend and was likely to continue to be on an upward trend, reflecting the rise in domestic and external demand. Members concurred that, while inventories had been more or less in balance with shipments in the industrial sector as a whole, inventories of electronic parts and devices had remained at a high level. A few members said that attention should continue to be paid to developments in inventories, noting that the problem of accumulated inventories in IT-related sectors had remained unresolved as firms, with new production lines coming into operation, had preferred to maintain high capacity utilization given increased production capacity. One of these members commented that the Indexes of Business Conditions remained sluggish, reflecting the fact that adjustments in IT-related sectors had been substantially reducing the momentum of growth in overall production.

As for employment and income, 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. Some members said that the weakness in regular payments did not reflect a widespread reduction in wages, which had been observed in the past, noting the following factors that were exerting downward pressure on wages per worker: a change in the composition of the workforce due to retirements in the baby-boomer generation; a reduction in salaries of local government employees; and a decline in working hours per worker due to the increase in part-time employment. Some members said that, given that firms were mindful of intensifying global competition, the current sluggishness in wage increases, particularly in regular payments, was unlikely to change substantially. They expressed the view, however, that it would gradually become difficult for firms not to raise wages, given the tightness in labor market conditions. One of these members added that various surveys showed that many firms were considering raising wages. On the other hand, a few other members said that if materials prices continued to surge, increases in wages might be postponed, especially in the services industry, where it was difficult for firms to absorb higher costs by improving productivity.

Based on the above discussion, members concurred that Japan's economy was likely to continue its sustained expansion with a virtuous circle of production, income, and spending in place, in line with the Bank's projection presented in the April *Outlook for Economic Activity and Prices* (hereafter the Outlook Report). In relation to the fact that Japan's economy continued to grow at about the same pace, one member said that this might be as a result of the weakening of correlation between industries and between firms partly due to the following factors. First, the driving force of Japan's economic growth had been multipolarized with the progress in economic globalization. And second, firms' cost structure had been diversified, and this had led to, for example, a significant decline in input of crude oil per unit of output. The member concluded that this kind of economic structure resulted in smaller economic fluctuations and made it difficult for firms to raise prices of their products, thereby leading to low inflation. The same member added that attention should be paid to the possibility that this structure could change in the event of a major shock.

As for prices, members noted that the three-month rate of change in the CGPI had turned positive again against the background of strong expansion in overseas economies and the consequent rise in international commodity prices, and agreed that the CGPI was likely to continue increasing. A few members said that a growing number of items in the CGPI had recently been rising, partly reflecting price revisions at the turn of the fiscal year in April.

Members concurred that the year-on-year rate of change in the CPI (excluding fresh food) was likely to be around 0 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. Some members said that underlying inflation pressures had been increasing steadily, albeit moderately, referring to recently observed developments in prices as follows. First, reflecting the recent rise in crude oil prices, prices of petroleum products such as gasoline had been rising, although the rate of increase was lower than in 2006. Second, in industries such as the food industry, where the profit margin was relatively low, firms had been passing on the rise in input prices, which had been caused by the increase in demand for those inputs overseas and the weakness in the yen, to the prices of many products. And third, the number of items showing a price rise had been exceeding that showing a decline, and this suggested that firms might have been gradually recovering their pricing power. In contrast, some members said that firms' pricing power seemed to have barely increased because competition among firms was intense and consumers were still strongly resistant to price rises. A different member said that the inflation rate in Japan had been low mainly reflecting developments in services prices, which might have been affected by trends in productivity and wages in the services industry. Based on the above discussion, members agreed that, while the rate of increase in the CPI would rise gradually as a trend, there remained considerable uncertainty about the precise pace of its rise in the immediate future. A few members commented that the effects of revisions of services prices since the turn of the fiscal year in April warranted attention.

B. Financial Developments

On the financial front, members concurred 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. With regard to the recent rise in real estate investment trust (REIT) prices, one member commented that it seemed to reflect an increase in the profitability of real estate investment, as evidenced by the rise in rents for office space now being more widely observed in metropolitan areas due to the tightening of supply-demand conditions.

III. Summary of Discussions on Monetary Policy for the Immediate Future

On the guideline for money market operations for the intermeeting period ahead, 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. They also concurred that their basic thinking remained unchanged on the monetary policy stance for the immediate future: 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.

Members discussed the Bank's communication of its thinking concerning the conduct of monetary policy. Referring to the stability in financial markets after the release of the April Outlook Report, some members expressed the view that the Bank communicated well, in a way that was consistent with the Bank's communication in the past, to market participants its outlook for economic activity and prices through fiscal 2008 and its basic thinking on the future conduct of monetary policy.

With regard to the Bank's future conduct of monetary policy, some members said that market participants remained keenly interested in the following points: what specific indicators the Bank would use to assess the degree of improvement in the economic and price situation; and how the Bank would conduct monetary policy in view of the fact that consumer prices had recently remained sluggish. In relation to this, many members expressed the view that the Bank should promote deeper understanding among market participants of its conduct of forward-looking monetary policy. One of these members added that it was important to assess developments in individual economic and price indicators from the viewpoint of whether they changed (1) the probability of the standard scenario materializing and (2) the risk scenario. A different member said that it was essential that the Bank continue to clearly explain the following basic points regarding the conduct of monetary policy. First, the effects of monetary policy took considerable time to work through the economy and the volatility of output might actually be amplified when attempts were made to absorb every short-term change in prices resulting from various shocks. Second, the Bank should therefore 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. And third, it was important to achieve sustained economic growth without large fluctuations by adjusting the level of interest rates in a gradual manner.

One member expressed the opinion that, since it was natural that the Bank had no predetermined time schedule of policy changes, emphasizing this point might only give market participants the impression that the Bank's conduct of monetary policy was difficult to understand. Against this opinion, some members said that one of the points about which the Bank had taken particular care when deciding on the wording of the April Outlook Report was that the timing of any policy change depended on developments in economic activity and prices. Based on this, these members stressed that the Bank should continue to explain this point carefully to ensure better understanding among market participants.

After the above discussion, members agreed that it was important to explain at every opportunity its thinking about the conduct of forward-looking monetary policy, and continue to clearly explain its assessment of both current and future developments in economic activity and prices.

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 estimates of real GDP for the January-March quarter of 2007, which showed an increase of 0.6 percent on a quarter-on-quarter basis and 2.4 percent on an annualized basis. However,

economic developments should continue to be watched closely as there had been 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 decline in the CPI had increased, 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) 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 was recovering, despite weakness in production in some sectors. A comprehensive review of developments in prices suggested that the economy had not yet overcome deflation. According to the first preliminary estimates of GDP for the January-March quarter released earlier in the day, real GDP growth was 0.6 percent on a quarter-on-quarter basis and 2.4 percent on an annualized basis, with nominal GDP growth of 0.3 percent and 1.2 percent, respectively. The GDP deflator continued to exhibit a year-on-year decrease. For fiscal 2006 as a whole, the year-on-year growth rates of real and nominal GDP were 1.9 percent and 1.3 percent, respectively.

(2) The government considered that developments in Japan's economy in fiscal 2006 were in line with its outlook. With regard to future economic activity and prices, however, 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.

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 May 17, 2007 and the whole report on May 18, 2007.[6]

VII. Approval of the Minutes of the Monetary Policy Meeting

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of April 9 and 10, 2007 for release on May 22, 2007.

[6] The English version of the whole report was published on May 21, 2007.

Attachment

May 17, 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.