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December 26, 2007

Bank of Japan

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# **Minutes of the Monetary Policy Meeting**

on October 31, 2007

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

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Secretariat of the Policy Board, Bank of Japan

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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 Wednesday, October 31, 2007, from 9:00 a.m. to 12:38 p.m.<sup>1</sup>

**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. H. Moriyama, 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, Associate Director-General, Monetary Affairs Department

Mr. T. Sekine, Senior Economist, Monetary Affairs Department

Mr. H. Nakaso, Director-General, Financial Markets Department

Mr. K. Momma, Director-General, Research and Statistics Department

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<sup>1</sup> The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on December 19 and 20, 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. E. Maeda, Associate 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, Deputy Head of Secretarial Services for the Board, Secretariat of the Policy Board

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

## **I. Summary of Staff Reports on Economic and Financial Developments<sup>2</sup>**

### **A. Money Market Operations in the Intermeeting Period**

The Bank conducted money market operations in accordance with the guideline decided at the previous meeting on October 10 and 11, 2007.<sup>3</sup> As a result, the uncollateralized overnight call rate had been at around 0.5 percent.

### **B. Recent Developments in Financial Markets**

In the money market, while interest rates on term instruments had been more or less flat, those on Euroyen futures had edged down. Long-term interest rates and stock prices declined. The yen appreciated to the range of 114-115 yen against the U.S. dollar.

### **C. Overseas Economic and Financial Developments**

The U.S. economy continued to be in a moderate adjustment phase. Housing investment continued to decrease, and the pace of decrease had recently been accelerating. Business fixed investment remained on a gradual uptrend, although the pace of increase was decelerating. Private consumption continued to be on an increasing trend, although the pace of increase was slower than before. As for prices, the year-on-year rate of increase in the consumer price index (CPI) for all items less food and energy, or the core CPI, had been slightly over 2 percent. Underlying inflation pressures remained as labor market conditions had continued to be tight.

In the euro area, the economy continued to expand with domestic and external demand well in balance. Exports continued to grow steadily, and private consumption remained on an upward trend as the employment situation had been improving steadily. Indicators of business sentiment, however, remained relatively weak. The U.K. economy continued to show relatively high growth, led mainly by domestic demand.

In China, both domestic and external demand continued to expand strongly. Exports continued to show a substantial increase, and the rate of increase in fixed asset investment remained high. The year-on-year rate of increase in the CPI for all items had

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<sup>2</sup> Reports were made based on information available at the time of the meeting.

<sup>3</sup> The guideline was as follows:

The Bank of Japan will encourage the uncollateralized overnight call rate to remain at around 0.5 percent.

been at a high level due to the rise in food prices. India's economy continued to show high growth, led mainly by domestic demand. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole.

In global financial markets, adjustments stemming from the U.S. subprime mortgage problem continued. Credit spreads had widened again, albeit slightly, compared with the time of the previous meeting. In money markets, deterioration in the liquidity of term instruments was little improved from the time of the previous meeting, although it had decreased somewhat compared with some time ago.

Under these circumstances, U.S. stock prices had fallen, in response to firms' lackluster earnings reports for the July-September quarter, weak housing-related indicators, and a further rise in crude oil prices. Long-term interest rates in the United States had also decreased due to a renewed "flight to quality." In Europe, developments in stock prices and long-term interest rates had basically followed those in the United States. In many emerging economies, stock prices had fallen and yield differentials between their sovereign bonds and U.S. Treasuries had expanded slightly.

#### **D. Economic and Financial Developments in Japan**

##### **1. Economic developments**

Exports had continued to increase against the background of the expansion of overseas economies. Real exports rose substantially, by 6 percent, in the July-September quarter from the previous quarter. Exports were expected to continue to rise against the background of the expansion of overseas economies as a whole.

In the corporate sector, profits had remained high and business fixed investment had continued to trend upward. Shipments of capital goods (excluding transport equipment), a coincident indicator of machinery investment, increased in the July-September quarter on a quarter-on-quarter basis for the second consecutive quarter.

With regard to the household sector, household income had continued rising moderately, although the unemployment rate had increased. In this situation, private consumption had been firm. Housing investment, however, had recently dropped sharply, affected by the revised Building Standard Law coming into force.

Production had continued to be on an increasing trend, reflecting the rise in domestic and external demand. It posted a solid increase in the July-September quarter,

partly due to progress in inventory adjustment in IT-related sectors. Inventories had been more or less in balance with shipments in the industrial sector as a whole.

On the price front, the three-month rate of change in the domestic corporate goods price index (CGPI) had continued to be positive, but the pace of increase in the CGPI had slowed somewhat mainly due to the appreciation of the yen. It was expected to continue to slow, although the CGPI was likely to continue increasing mainly due to the rise in international commodity prices. The year-on-year rate of change in the CPI (excluding fresh food) had been around 0 percent, and it was expected to continue to be around 0 percent in the short run. 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. Credit demand in the private sector had been more or less flat lately, since ample cash flow had slowed the increase in corporate demand for external funds. The issuing environment for CP and corporate bonds had been favorable, and the lending attitudes of private banks had continued to be accommodative. Under these circumstances, the amount outstanding of CP and corporate bonds issued had been above the previous year's level, and the amount outstanding of lending by private banks had been increasing moderately. Funding costs for firms had risen slightly. The year-on-year rate of growth in the money stock ( $M_2$ +CDs) was around 2 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. They also agreed that economic activity in the first half of fiscal 2007 was generally in line with the projection in the April 2007 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), although the pace of improvement in the household sector had remained slow relative to the strength in the corporate sector.

Members agreed that overseas economies taken as a whole continued to expand with momentum being gained across a wide range of economies. With regard to the U.S.

economy, members shared the view that private consumption and business fixed investment remained firm so far although the correction in the housing market had turned out to be larger than previously expected, and the pace of growth of the economy was slowing moderately. Some members noted, however, that downside risks to the U.S. economy had increased: anecdotal information suggested that the negative effects of the subprime mortgage problem had begun to spread to the commercial real estate market, and consumer confidence had deteriorated. Many members said that European economies continued to expand steadily and the Chinese economy continued to show high growth.

In the discussion of developments in overseas economies, many members noted a surge in crude oil prices and other international commodity prices. Some members said that the surge was mainly due to the ongoing expansion of the global economy, especially emerging economies, but could also have been caused by a speculative inflow of funds to commodity markets. Members concurred that developments in crude oil prices and their effects on the global economy continued to warrant careful attention.

Members shared the view that Japan's exports as a whole had continued to increase amid these developments in overseas economies.

As for domestic private demand, members agreed that business fixed investment continued to increase, reflecting the high level of corporate profits. They also concurred that private consumption had been firm reflecting the gradual increase in household income, although recent developments in some indicators, for example, a rise in the unemployment rate in September, had raised concern.

Members discussed how to interpret, from a macroeconomic viewpoint, the fact that there were many indicators showing relatively weak developments in small firms. Some members were of the view that this comparative sluggishness was due to the structural factor whereby small firms tended to benefit less from economic globalization than large ones. A different member added that the sluggishness in small firms could also be attributable to production in the economy as a whole having stayed level in the first half of fiscal 2007. Some members said that small firms were affected by the deterioration in the terms of trade, being unable to pass on the rise in materials prices, such as crude oil prices, to sales prices. Members agreed that, from a macroeconomic viewpoint, developments in small firms tended to affect the number of employees and total wages, and it was therefore necessary to examine what effect developments in small firms would have

on the transmission mechanism by which the strength in the corporate sector fed through into the household sector.

Members agreed that housing investment had dropped sharply, affected by the revised Building Standard Law coming into force. Some members commented that the easing of the practical application of the revised Building Standard Law might alleviate the sluggishness in housing investment. They also said, however, that some in the real estate industry were saying that housing demand was peaking out.

Members concurred that production, which was flat in the first half of the year, posted a solid increase in the July-September quarter, especially in IT-related goods, and inventory adjustments in electronic parts and devices seemed to have almost been completed.

As for prices, members said that the three-month rate of change in the CGPI had been slightly positive, due to the rise in international commodity prices, and the CGPI was likely to continue increasing in the immediate future, although the pace of increase was expected to slow somewhat.

With regard to the fact that the year-on-year rate of change in the CPI (excluding fresh food) continued to be around 0 percent, members agreed that firms were making various cost-saving efforts to restrain sales prices in the face of intensified competition among firms amid economic globalization and deregulation.

A few members expressed the view that the year-on-year rate of change in the CPI might turn positive in the near future, given the recent high level of crude oil prices and the rise in prices of daily necessities. One member was of the view that, if the current high level of crude oil prices continued, the year-on-year rate of increase in the CPI was likely to accelerate until early fiscal 2008, mainly due to the base effect associated with the previous year's fall in crude oil prices. A few members including this member added that, if crude oil prices did not rise further, the contribution of the high level of crude oil prices to the year-on-year rate of increase in the CPI would be reduced in the second half of fiscal 2008 by the disappearance of the base effect.

Meanwhile, a few members said that it was confirmed in the October *Regional Economic Report* and reports at the meeting of general managers of the Bank's branches that almost all the regional economies were expanding moderately or were on a recovery trend, although there were differences in degree.

## **B. Financial Developments**

Members shared the view that developments in global financial markets remained unstable amid the ongoing risk reassessment. With regard to the recently released earnings reports of some U.S. and European financial institutions, because of the ongoing repricing some members were of the view that uncertainty regarding their unrealized losses had not yet been resolved or that it had rather increased. They continued that this uncertainty was negatively affecting prices of stocks and securitized products. One member added that the repricing had also reduced the earnings of insurance companies, notably monoline insurers. Members agreed, however, that developments in the lending attitudes of financial institutions and the issuing environment for CP and corporate bonds suggested that the financial environment in Japan continued to be extremely accommodative, despite the swings in global financial markets.

## **C. Outlook for Economic Activity and Prices**

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

Members noted the following as the background to this economic outlook. First, although the slowdown in U.S. economic growth had been protracted, due mainly to the correction in the housing market, exports were likely to remain on the increase as growth in other overseas economies was likely to remain high. Second, strong corporate performance was expected 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 shared the view that, although swings in housing investment might cause fluctuations in economic growth, the annual rate of real GDP growth was likely to register around 2 percent on average, somewhat higher than the potential growth rate.

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 gradually.

Members concurred that the rate of increase in the CGPI had recently been higher than the previous projection in April, reflecting rises in international commodity prices, and as for the outlook the CGPI 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 developments in the CPI (excluding fresh food) had been generally in line with the previous projection, and the year-on-year rate of change had recently been around 0 percent. 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, but was likely to rise gradually in the longer run.

Members shared the view that upside and downside risks to the above outlook were as follows: in relation to economic activity, (1) developments in overseas economies and (2) possible larger swings in financial and economic activity under continuing accommodative 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 overseas economies, members discussed what assessment they should make regarding the risk that the U.S. economy might be weaker than expected and this might have a negative impact on the global economy. One member said that housing investment in the United States had only relatively limited effects on other economies and therefore, in examining the impact on the global economy, it was important to evaluate the extent to which the correction in the U.S. housing market and the resultant turbulence in financial markets would affect private consumption and business fixed investment in the United States. A different member commented that a further correction in housing prices might lead to a greater-than-expected deceleration of U.S. economic growth, considering that the recent surge in crude oil prices could also adversely affect private consumption. Some members noted that the downside risks to European economies stemming from global financial market disruptions were not negligible. Many members said that there were also some inflation risks to the global economy, given the high level of resource utilization in the U.S. economy, signs of overheating in the Chinese economy, and the surge in crude oil prices.

As for the effects of the accommodative financial environment, members shared the view that Japanese financial conditions remained extremely accommodative, despite the U.S. subprime mortgage problem and the consequent volatility in global financial markets, and Japan's current economic circumstances were such as potentially to encourage assertive financial and economic activity. They 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.

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 assumed to changes in the output gap. A few 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. Meanwhile, some members said that prices might rise higher than expected because firms' capacity to absorb higher costs had been approaching its limit and consumers seemed to be gradually starting to accept higher sales prices arising from higher costs. One of these members commented that the recent signs of a rise in wages warranted attention. Members agreed that considerable uncertainty surrounded developments in the prices of crude oil and other commodities, leaving the potential for movement in either direction.

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 growth in production, income, and spending in place.

Members then made an assessment in terms of the second perspective, that is to say, they examined the risks considered most relevant to the conduct of monetary policy, extending the time horizon. They concurred that the two risks warranting attention were the risk of the expectation taking hold that interest rates would remain low and the

downside risk to economic activity and prices. One member expressed the view that the subprime mortgage problem and the disruptions in global financial markets had the following implications for the conduct of monetary policy. First, they were examples of the materialization of the risk arising from laxity in risk evaluation under the continued benign economic environment -- a risk about which the Bank had warned in, for example, Outlook Reports -- and therefore they underscored the necessity to adjust the level of interest rates in accordance with improvements in the economic and price situation from a longer-term perspective. And second, at the same time they had led to a self-correction in the form of a swing back in the markets, increasing economic uncertainty in the short run.

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: (1) the level of interest rates was to be raised if Japan's economy was to follow a path of sustainable growth under price stability; and (2) interest rates should be adjusted flexibly without any predetermined view, depending entirely on developments in economic activity and prices.

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

On the guideline for money market operations for the intermeeting period ahead, one member said that it would be appropriate to raise the uncollateralized overnight call rate target from around 0.5 percent to around 0.75 percent.

Against this view, most members said that it would be 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 expressed the following view: economic indicators suggested that Japan's economy was likely to continue sustainable growth under price stability broadly in line with the projection presented in the April Outlook Report; however, global financial markets continued to be unstable, and there was uncertainty regarding global economic developments, for example, downside risks to the U.S. economy; and therefore the Bank should continue to examine economic indicators and other relevant information as well as financial market conditions carefully.

#### **IV. Remarks by Government Representatives**

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

- (1) Japan's economy as a whole continued to experience a sustained recovery, although some weaknesses had been seen recently. The CGPI had been increasing, albeit at a slower pace recently, while the CPI had been more or less unchanged.
- (2) 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 so as to ensure the sustainability of the ongoing economic recovery.
- (3) The subprime mortgage problem, which had begun to be resolved, still required careful monitoring. The government would like the Bank to carefully monitor developments in the Japanese and the global economy, particularly the U.S. economy, and also in financial markets, and continue to react appropriately to changes in trends. The Ministry of Finance would also give due consideration to developments in the economy and financial markets, both at home and abroad.
- (4) Market participants were focusing on what assessment the Bank would make of the outlook for economic activity and prices in fiscal 2007 and fiscal 2008, taking into account developments in economic activity and prices after the swings in financial markets triggered by the subprime mortgage problem, and how the Bank would outline its thinking on the future conduct of monetary policy in the October Outlook Report, whose text would be decided later in this meeting. The government would therefore like the Bank to clearly explain to market participants and the public its view regarding the current situation and future course of Japan's economy and its thinking on the future conduct of monetary policy.

The representative from the Cabinet Office made the following remarks.

- (1) Japan's economy was recovering, although some weaknesses had been seen recently. Housing construction had recently been decreasing, affected by the revised Building Standard Law coming into force. A comprehensive review of developments in prices suggested that the economy had not yet overcome deflation. The year-on-year rate of change in the CPI had recently been negative, and inflation pressures stemming from domestic factors had still been weak. This was because the feed-through of the strength in the corporate sector into the household sector had slowed, and wages were

not rising in tandem with the tightening labor market conditions. The rate of change in the CPI was likely to eventually turn positive, and therefore price developments should be monitored carefully, paying close attention to when the upturn occurred.

- (2) As stated in the draft for the October Outlook Report, due attention should be paid to downside risks to Japan's economy such as the possibility that developments in overseas economies, particularly in the United States, in crude oil prices, and in global financial markets might negatively affect Japan's economy. In order to ensure sustainable economic growth led by private demand and achieve a stable inflation rate that would be compatible with that growth, it was important for the government and the Bank to implement their policies based on the shared basic perspective on macroeconomic management.
- (3) The government would like to request the Bank to implement effective monetary policy that was consistent with the government's policy efforts and outlook for the economy, and to firmly support the economy from the financial side, paying due attention to economic and price developments in view of downside risks to the outlook for economic activity and prices.

## V. Votes

Based on the above discussions, most 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.

One member, however, said that the member would like to propose that the Bank should raise the uncollateralized overnight call rate target from around 0.5 percent to around 0.75 percent.

As a result, the following proposal was submitted and put to the vote.

Mr. A. Mizuno proposed the following guideline for money market operations for the intermeeting period ahead:

The Bank of Japan will encourage the uncollateralized overnight call rate to remain at around 0.75 percent.

The proposal was defeated by a majority vote.

Votes for the proposal: Mr. A. Mizuno.

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

To reflect the majority 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. K. G. Nishimura, Mr. T. Noda, Mr. S. Nakamura, and Mr. H. Kamezaki.

Votes against the proposal: Mr. A. Mizuno.

Mr. A. Mizuno dissented from the above proposal for the following reasons. First, developments in Japan's economy had been in line with the projection in the Outlook Report. Second, a change in the projection for Japan's economy was not necessary because swings in financial markets triggered by the U.S. subprime mortgage problem continued to be only one of the risks to Japan's economy. And third, postponing the decision to raise the policy interest rate target might leave interest rates at levels inconsistent with economic fundamentals even longer.

**VI. Discussion on the *Outlook for Economic Activity and Prices***

Members discussed the draft of the *Outlook for Economic Activity and Prices* (consisting of "The Bank's View" and "The Background"), and put "The Bank's View" to the vote. The Policy Board decided, by a unanimous vote, the text of "The Bank's View."

It was confirmed that "The Bank's View" would be published on October 31, 2007 and the whole report on November 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.

## **VII. Approval of the Minutes of the Monetary Policy Meeting**

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of September 18 and 19, 2007 for release on November 5, 2007.

Attachment

October 31, 2007

Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by an 8-1 majority vote,<sup>[Note]</sup> 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.

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<sup>[Note]</sup> Voting for the action: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. K. G. Nishimura, Mr. T. Noda, Mr. S. Nakamura, and Mr. H. Kamezaki.  
Voting against the action: Mr. A. Mizuno.