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June 18, 2008

Bank of Japan

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# **Minutes of the Monetary Policy Meeting**

on May 19 and 20, 2008

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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 Monday, May 19, 2008, from 2:00 p.m. to 4:17 p.m., and on Tuesday, May 20, from 9:00 a.m. to 12:00 p.m.<sup>1</sup>

#### **Policy Board Members Present**

**Mr. M. Shirakawa, Chairman, Governor of the Bank of Japan**

**Mr. K. G. Nishimura, Deputy Governor of the Bank of Japan**

**Ms. M. Suda**

**Mr. A. Mizuno**

**Mr. T. Noda**

**Mr. S. Nakamura**

**Mr. H. Kamezaki**

#### **Government Representatives Present**

Mr. H. Moriyama, Senior Vice Minister of Finance, Ministry of Finance<sup>2</sup>

Mr. M. Suzuki, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance<sup>3</sup>

Mr. J. Hamano, Vice Minister for Policy Coordination, Cabinet Office

#### **Reporting Staff**

Mr. H. Yamaguchi, Executive Director

Mr. A. Horii, Executive Director (Assistant Governor)

Mr. K. Ido, Executive Director

Mr. K. Yamamoto, 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

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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 June 12 and 13, 2008 as "a document describing an outline of the discussion at the meeting" stipulated in Article 20, paragraph 1 of the Bank of Japan Act of 1997. Those present are referred to by their titles at the time of the meeting.

<sup>2</sup> Mr. H. Moriyama was present on May 20.

<sup>3</sup> Mr. M. Suzuki was present on May 19.

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

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

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. Nakamura, Senior Economist, Monetary Affairs Department

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

## **I. Summary of Staff Reports on Economic and Financial Developments<sup>4</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 April 30, 2008.<sup>5</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, Euroyen rates and interest rates on term instruments, such as yields on financing bills (FBs) and treasury bills (TBs), had been more or less flat on the whole. Interest rates on Euroyen futures had also been more or less unchanged, albeit with some fluctuations.

Japanese stock prices had trended upward following U.S. and European stock prices, albeit with some fluctuations. The Nikkei 225 Stock Average had been moving in the range of 14,000-14,500 yen recently.

Long-term interest rates continued to fluctuate widely following those in the United States and Europe. They had recently been at around 1.6-1.7 percent.

The yen remained more or less unchanged against the U.S. dollar, and had recently been traded in the range of 104-105 yen against the dollar.

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

Growth in the U.S. economy had remained sluggish. Adjustments in the housing market had persisted, private consumption had continued to be more or less unchanged, and a slowdown in business fixed investment had become more evident. Industrial production and the number of employees had also been on a declining trend. In this situation, financial institutions had been applying tighter lending standards to a broad range of borrowers. As for prices, the year-on-year rate of increase in consumer prices had been elevated, not only in terms of the consumer price index (CPI) for all items but also the CPI for all items less energy and food, or the core CPI, which registered a year-on-year rate of

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<sup>4</sup> Reports were made based on information available at the time of the meeting.

<sup>5</sup> The guideline was as follows:

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

increase of 2.0-2.5 percent.

The economy of the euro area continued to grow, although the pace of growth was slowing moderately. Housing investment had decreased slightly, and the pace of growth in private consumption had slowed due to the rise in energy and food prices and to uncertainty about the outlook for the economy. Meanwhile, business fixed investment was on an upward trend. Exports, the growth of which lost momentum temporarily, had resumed their increasing trend. However, survey results suggested that their growth was likely to slow. As for prices, the year-on-year rate of increase in the Harmonized Index of Consumer Prices (HICP) continued to be relatively high, reflecting the rise in energy and food prices. The U.K. economy continued to grow, albeit with a moderate slowing of the pace of growth.

In China, both domestic and external demand continued to expand strongly. India's economy continued to show relatively high growth, although it was slowing moderately. The NIEs and ASEAN economies as a whole continued to expand at a moderate pace since domestic demand remained firm, although a slowdown in exports was becoming evident. As for prices, the year-on-year rate of increase in the CPI for all items had risen in many Asian economies due to the rise in energy and food prices.

In global financial markets, instability continued as seen in the persisting strains in money markets, although overly pessimistic views about global financial markets had subsided compared with some time ago. In the U.S. and European financial markets, stock prices and long-term interest rates rose, albeit with large fluctuations. In emerging economies, developments in stock prices followed those in the United States and Europe, and yield differentials between their sovereign bonds and U.S. Treasuries narrowed temporarily reflecting developments in U.S. interest rates but expanded thereafter.

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

### **1. Economic developments**

Exports had continued to increase against the background of the expansion of overseas economies, posting a solid increase in the January-March quarter from the previous quarter. They were expected to continue to rise, as overseas economies were likely to expand although at a slower pace.

As for domestic private demand, the pace of increase in business fixed investment

had become slower in a situation where corporate profits had been leveling off, albeit at a high level. Firms' forecasts of machinery orders, a leading indicator of machinery investment, for the April-June quarter showed a significant drop from the previous quarter. Historically, actual machinery orders tended to be stronger than the forecasts, but due attention should be paid to developments in machinery orders this year in view of the recent environment for corporate profits.

Private consumption had been firm. With regard to durable consumer goods, the number of new passenger-car registrations had been more or less unchanged lately, after picking up in the second half of 2007 supported mainly by the introduction of new models. Sales of electrical appliances had continued to increase. As for nondurable and semi-durable consumer goods, sales at department stores had been somewhat weak, notably in apparel and general merchandise. Sales at supermarkets and convenience stores, including those of foods, had been more or less flat. As for services consumption, outlays for travel had been firm, while sales in the food service industry had been leveling off. Consumer sentiment had been generally cautious, due mainly to rises in prices of petroleum products and food products. Private consumption was expected to remain firm, reflecting the gradual increase in household income.

Housing investment had been recovering moderately. The number of housing starts, a leading indicator of housing investment, continued to pick up until January 2008, but since then it had leveled off. The slowdown in the pace of recovery seemed to be mainly due to the softness in sales of condominiums and further increases in prices of structural steel. Housing investment was expected to be on a recovery trend, but the pace was likely to be modest.

Production had been more or less flat. In light of developments in demand both at home and abroad, production was expected to remain more or less flat in the short run and increase thereafter. Inventories had been more or less in balance with shipments.

As for employment and income, in a situation where firms were strongly feeling a shortage of labor, household income had continued rising moderately. The year-on-year rate of change in nominal wages per worker had been positive lately. The gradual increase in household income was likely to continue against the background of the persisting labor shortage and the generally high, although slightly reduced, corporate profits.

On the price front, international commodity prices showed the following

developments: crude oil prices had continued to rise; prices of nonferrous metals had also been high; and prices of crops had shown mixed developments, with wheat prices falling back and corn prices rising. The three-month rate of change in the domestic corporate goods price index (CGPI) had been positive, mainly due to the rise in international commodity prices, and the CGPI was likely to continue increasing for the time being. The year-on-year rate of change in the CPI (excluding fresh food) had been rising since around the end of 2007 and had been around 1 percent lately. It was projected to continue to be positive due to the rise in prices of petroleum products and food products in a situation where aggregate supply and demand in the economy were more or less balanced.

## 2. Financial environment

The environment for corporate finance was accommodative. Credit demand in the private sector had been more or less flat. The issuing environment for CP and corporate bonds had been favorable as a whole, although issuance spreads on those issued by firms with low credit ratings had expanded. The lending attitudes of private banks had continued to be generally accommodative, and the amount outstanding of lending by private banks had been increasing moderately. The amount outstanding of CP and corporate bonds issued had been above the previous year's level. Funding costs for firms had been more or less unchanged. The financial positions of firms had continued to be favorable as a whole, although those of small and medium-sized firms had deteriorated somewhat. 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**

Members agreed on the following assessment of the current state of Japan's economy: economic growth was slowing, mainly due to the effects of high energy and materials prices; the economy was likely to grow at a slower pace for the time being and follow a moderate growth path thereafter; however, due attention should continue to be paid to factors such as uncertainty regarding future developments in overseas economies and global financial markets, and to the effects of high energy and materials prices.

Members agreed that, although overseas economies taken as a whole continued to



expand, downside risks remained elevated as the disruptions in global financial markets had continued and growth in the U.S. economy had been sluggish.

Members shared the view that, although overly pessimistic views about global financial markets, which had been prevalent among market participants through the middle of March, had subsided, instability continued in global financial markets as seen in the persisting strains in money markets and the tightening lending standards of financial institutions. Some members said that the strains in money markets persisted, although measures taken by central banks to enhance liquidity provision to them had been effective to some extent as seen in, for example, a slight narrowing of Treasury-Eurodollar (TED) spreads compared with some time ago. Regarding corporate finance, some members noted that credit spreads remained at high levels. Many members said that attention should be paid to the effects on economic activity of the further tightening of financial institutions' lending standards.

With regard to the U.S. economy, members shared the view that there was considerable uncertainty regarding when and how the negative feedback loop between financial markets, asset prices, and economic activity would diminish. Some members said that home prices continued to fall and adjustments in the housing market were still continuing. A few members remarked that private consumption had been more or less unchanged as a whole, given that retail sales had been relatively firm while sales of automobiles had been sluggish partly due to the surge in gasoline prices. A few other members said that the risk that the U.S. economy would weaken significantly had decreased somewhat as corporate results turned out to be stronger than expected, except in the financial and construction industries.

With regard to European economies, members shared the view that the economy of the euro area continued to grow, although the pace of growth was slowing moderately. On Asian economies, members concurred that China and India continued to show high growth, and that the NIEs and ASEAN economies as a whole continued to expand at a moderate pace although the pace of growth in exports had started to slow. A few members said that close attention should be paid to the adverse effects of the recent earthquake in China on economic and price developments there, although there was only limited information at the moment.

Regarding global price developments, members agreed that inflation risks had

been heightening worldwide given the high international commodity prices, particularly crude oil prices. Many members said that the recent rise in the prices of primary commodities was not only due to increased demand brought about by growth in emerging economies, but also to various other factors such as supply constraints, heightened geopolitical risks, accommodative financial conditions, and a "flight to simplicity." A few members commented that it would be inappropriate to focus only on the outflow of income that the current surge in primary commodity prices had caused -- a supply shock -- since it had occurred in parallel with an increase in Japan's exports to emerging economies and countries exporting natural resources.

Members concurred that Japan's exports had continued to increase to a broad range of regions, as overseas economies were expanding although at a slower pace, and they were likely to continue to increase. One member, however, said that some firms were raising their export prices reflecting the rise in materials prices and the appreciation of the yen, and the member would closely monitor how this, coupled with the slowdown in overseas economies, affected developments in exports.

As for domestic private demand, members agreed that the pace of increase in business fixed investment had become slower in a situation where corporate profits had been leveling off due mainly to the rise in energy and materials prices. Some members noted that the economy's capacity to generate income had been reduced by the deterioration in the terms of trade, as evidenced by the GDP statistics for the January-March quarter, in which the year-on-year rate of change in gross domestic income had become negative. They continued that careful attention should be paid to the possibility that this might reduce domestic private demand. A few members commented that the growth of profits of firms, particularly small firms, was slowing reflecting the rise in materials prices and the appreciation of the yen, and it seemed that their stance on fixed investment and employment had become cautious. Members concurred that business fixed investment was likely to remain firm but increase at a slower pace. With regard to firms' forecasts of machinery orders for the April-June quarter, many members commented that the sharpness of the drop -- although historically actual machinery orders tended to be stronger than the forecasts -- might suggest that it was partly attributable to the leveling-off of corporate profits. These members said that they would closely monitor developments in business fixed investment, including the extent to which business fixed investment plans were revised in the upcoming

June 2008 *Tankan* (Short-Term Economic Survey of Enterprises in Japan).

Members concurred that private consumption had been firm and was likely to remain so, reflecting the gradual increase in household income. Some members said, however, that since private consumption in the GDP statistics for the January-March quarter might have been stronger than the underlying trend of private consumption because of the effect of the leap day and consumer sentiment remained relatively weak, attention should be paid to future developments in private consumption.

As for employment and income, members agreed that household income had continued rising moderately. Some members said that the year-on-year rate of change in regular payments had recently been positive. A few members, however, were of the opinion that the growth in summer bonus payments was likely to be relatively small reflecting the leveling-off of corporate profits. Regarding the number of employees, many members said that the number of regular employees in the *Monthly Labour Survey*, which fluctuated relatively little from month to month, had been increasing by around 2 percent year on year, while the *Labour Force Survey*, which covered a wider range of workers, showed some weakness, and they expressed the view that marginal demand for labor might have slackened, especially among small firms.

Members agreed that housing investment had been recovering moderately. They were of the opinion that it was likely to be on a recovery trend, but the pace was likely to be modest. One member said that there was some weakness in demand for housing, particularly condominiums, partly due to the earlier rise in prices.

Members agreed that production had been more or less flat lately, and was likely to remain so in the short run and increase thereafter.

As for prices, members said that the three-month rate of change in the CGPI had been positive, mainly due to the rise in international commodity prices, and the CGPI was likely to continue increasing for the time being.

Members concurred that the year-on-year rate of change in the CPI (excluding fresh food) was likely to continue to be positive due to the rise in prices of petroleum products and food products in a situation where aggregate supply and demand in the economy were more or less balanced. Some members said that attention should be paid to the effects of the ongoing rise in the prices of daily necessities on consumers' inflation expectations and firms' price-setting behavior. Some other members commented that,

although the year-on-year rate of increase in the CPI for April was expected to be lower than that for March because of the expiration on April 1, 2008 of the law levying the provisional tax on, for example, gasoline, firms continued to pass on higher costs to gasoline and food product prices, and thus the underlying upward momentum of the CPI remained unchanged.

## **B. Financial Developments**

Members concurred that financial conditions in Japan remained accommodative. They also agreed that the issuing environment for CP and corporate bonds had been favorable as a whole, although issuance spreads on those issued by firms with low credit ratings had expanded, and that the lending attitudes of financial institutions had been generally accommodative. Members also shared the view that the Japanese money market continued to be quite stable compared with its U.S. and European counterparts. Some members said, however, that the Japanese bond market had recently been unstable.

## **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, given the economic and financial situation, it would be appropriate to maintain the current guideline that the Bank would encourage the uncollateralized overnight call rate to remain at around 0.5 percent. They shared the following view: (1) Japan's economy was likely to grow at a slower pace for the time being, due to the effects of high energy and materials prices, and follow a moderate growth path thereafter; (2) however, there remained considerable downside risks including uncertainty regarding future developments in overseas economies and global financial markets; and (3) in this situation, it was appropriate to carefully examine economic and financial developments at home and abroad to grasp the situation more accurately.

Members concurred that the following thinking on the monetary policy stance for the future presented in the April 2008 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) remained unchanged: the Bank would carefully assess the future outlook for economic activity and prices, closely considering the likelihood of its projections materializing as well as factors posing upside or downside risks, and would implement its policies in an accordingly flexible manner. A few members said that,

although there were considerable downside risks to the economy, the Bank should explain to the public that in making policy decisions it always paid close attention to both economic and price developments.

With regard to the inflation caused by the rise in energy and materials prices, members discussed its background and policy action to be taken by the Bank. One member said that the recent rise in the prices of primary commodities had caused both supply and demand shocks to Japan's economy and that it was notable that these shocks were persistent. This member also remarked that, in textbook theory, the Bank would not need to take policy action to absorb the first-round effects of supply shocks unless they caused second-round effects through a change in inflation expectations. This member continued that the effects of the current supply and demand shocks were so persistent and complex that deciding what policy action to take was becoming more difficult. Some members pointed to economic fundamentals, namely, high growth in emerging economies, as a background to the recent rise in the prices of primary commodities, and said that this had caused both an increase in exports -- a demand shock -- and a rise in import prices -- a supply shock -- to Japan's economy. These members also commented that close attention should be paid to how these shocks affected the overall supply-demand balance. One member said that a rise in the prices of primary commodities caused a change in relative prices and a consequent adjustment in resource allocation, but could also lead to a substantial change in the level of general prices depending on consumers' inflation expectations and firms' price-setting behavior. This member continued that the Bank therefore should implement monetary policy paying attention to these developments.

Members discussed what type of price indicator should be monitored most closely amid this environment surrounding prices. One member said that, in a situation such as the present one, where energy and materials prices had been increasing persistently, due attention should be paid to the possibility that the core CPI, which excluded these prices and was a frequently used price indicator in the United States, might not be indicating the underlying trend of prices. A different member pointed out the importance of having criteria to determine what type of price indicator was useful to discern the medium- to long-term trend of the headline CPI. As useful price indicators for this purpose, another member mentioned the CPI excluding fresh food and the trimmed mean of the CPI. One member said that the CGPI remained an important indicator in a situation such as the

present one, where higher energy and materials prices had been passed on to prices downstream. Based on the discussion, members concurred that it would be appropriate to aim at achieving sustainable economic growth with price stability in the medium to long term by discerning the trend of consumer prices through careful monitoring of various price indicators.

Many members said that the Risk Balance Charts in the April 2008 Outlook Report acted as an effective tool for communicating with market participants, because each of the Risk Balance Charts visually showed the aggregated probability distribution of both upside and downside risks to the outlook for economic activity and prices. A few members commented that, under certain circumstances, the Risk Balance Charts might cause misunderstanding about members' thinking, and thus it remained important that the Bank disseminate, together with the charts, the content of members' qualitative discussions published in the Outlook Report. A few members noted that central banks worldwide frequently reviewed their communication tools, and said that the Bank should always strive to ensure that it employed effective ones. Many members said that the Bank should decide whether it would continue to release the Risk Balance Charts after carefully assessing the market's reaction.

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

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

- (1) There appeared to be a pause in Japan's economic recovery recently, as evidenced by the fact that corporate profits had been somewhat weak and production had been flat. Domestic corporate goods prices had been rising due to increased materials prices. Consumer prices excluding prices of petroleum products and some other components had risen only slightly.
- (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 economic recovery.
- (3) Developments in the U.S. subprime mortgage problem, in crude oil prices, and in the global economy, particularly the U.S. economy, should continue to be watched closely. The government would like the Bank to carefully monitor both the effects of developments in these areas on Japan's economy and developments 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) Furthermore, the government would 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) There appeared to be a pause in Japan's economic recovery recently, as evidenced by the fact that private consumption, business fixed investment, and production had continued to be flat. Although Japan's economy was expected to resume its moderate recovery, future developments warranted careful attention since the downside risks to the economy were increasing. Price developments should continue to be watched closely.
- (2) 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) In view of present economic conditions and the rise in downside risks, the government had been implementing policy measures described in "Earlier Implementation Measures towards the Strengthened Growth." The government would like to request the Bank to implement effective monetary policy that was consistent with the government's policy efforts and its outlook for the economy, and to firmly support the economy from the financial side, paying due attention to downside risks to the outlook for the economy 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. M. Shirakawa, Mr. K. G. Nishimura, Ms. M. Suda, Mr. A. Mizuno, 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 20, 2008 and the whole report on May 21, 2008.<sup>6</sup>

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

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of April 8 and 9, 2008 for release on May 23, 2008.

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<sup>6</sup> The English version of the whole report was published on May 22, 2008.



Attachment

May 20, 2008

Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by a unanimous 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. M. Shirakawa, Mr. K. G. Nishimura, Ms. M. Suda, Mr. A. Mizuno, Mr. T. Noda, Mr. S. Nakamura, and Mr. H. Kamezaki.  
Voting against the action: None.