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Statement by Toshihiko Fukui, Governor of the Bank of Japan, concerning the Bank's *Semiannual Report on Currency and Monetary Control*

before the Committee on Financial Affairs, House of Councillors, on October 18, 2005

INTRODUCTION

The Bank of Japan submitted its *Semiannual Report on Currency and Monetary Control* for the second half of fiscal 2004 to the Diet in June 2005. I am pleased to have this opportunity to present an overall review of the Bank's conduct of monetary policy.

I. Developments in Japan's Economy

Japan's economy has emerged from its temporary pause that started during the summer of 2004, and continues to recover.

Exports are continuing to increase moderately against the background of the expansion of overseas economies, although the momentum of export growth, especially to China, weakened temporarily. Production is on an uptrend with some fluctuations, partly due to the completion of inventory adjustment in IT-related sectors. Business fixed investment is growing steadily in a wide range of industries, as corporate profits remain high and business sentiment has been showing a gradual improvement. As for the household sector, after a prolonged period of difficulty due to firms' efforts to reduce excess labor and personnel expenses, household income has been rising moderately, as the number of employees has been increasing and wages have picked up. With this improvement in the employment and income situation, private consumption has been steady.

Looking forward, exports are expected to continue rising against the background of the expansion of overseas economies. Domestic private demand is likely to continue increasing against the backdrop of high corporate profits and the moderate rise in household income, as structural adjustment pressure stemming from firms' excess capacity and labor has almost dissipated. Given this situation, the economy is likely to experience a relatively long period of growth, albeit at a moderate pace. Nevertheless, there are risk factors such as the continuing surge in crude oil prices and its possible effect on overseas economies, and these should be monitored closely.

On the price front, domestic corporate goods prices have been increasing mainly reflecting the effects of high crude oil prices, and this uptrend is expected to continue. Consumer prices (excluding fresh food, on a nationwide basis) have been declining slightly on a year-on-year basis partly due to the reduction in electricity and telephone charges against the background of such factors as deregulation. The year-on-year rate of change in consumer prices is projected to be zero percent or a slight increase toward the end of the year, as the effects of temporary factors, such as the decline in rice prices and the reduction in electricity and telephone charges, fall off. The year-on-year rate of change in the consumer price index (CPI) is expected to increase thereafter, as the Japanese economy is likely to continue growing at above its potential rate, causing the gap between supply and demand to shrink further.

On the financial front, the environment for corporate finance is becoming more accommodative on the whole. The lending attitude of financial institutions has been becoming more active. Under these circumstances, the negative year-on-year change in the amount of lending by private banks observed since 1998 has gradually improved, and the amount of their lending is currently at around the previous year's level. The environment in the capital markets for firms raising funds through CP and corporate bonds continues to be favorable.

II. Conduct of Monetary Policy

The Bank has been providing ample liquidity based on the quantitative easing policy. At the Monetary Policy Meeting (MPM) on October 11 and 12, 2005, the Policy Board decided to maintain the target range for the outstanding balance of current accounts held at the Bank at "around 30 to 35 trillion yen."

The framework of the quantitative easing policy is based on two key elements. The first element is the Bank's provision of ample liquidity to the money market so that the outstanding balance of current accounts at the Bank substantially exceeds the amount of required reserves. The second is the Bank's commitment to firmly maintain this ample provision of liquidity until the year-on-year rate of change in the CPI registers zero percent or higher on a sustainable basis.

Regarding the first element, the Bank's provision of ample liquidity contributed greatly to maintaining financial system stability and an accommodative corporate financing environment by responding to financial institutions' precautionary demand for liquidity when there were strong concerns about financial system stability. Since then, such concerns have largely subsided, as evidenced by the smooth implementation of the full removal of blanket deposit insurance in April 2005. As a result, financial institutions' precautionary demand for liquidity has been on a declining trend. Under these circumstances, since the MPM held on May 19 and 20, 2005, the Bank has been allowing the outstanding balance to temporarily fall below the target range when it is judged, in a situation where the Bank is doing its utmost to provide funds while at the same time giving due consideration to the effects on the functioning of the market, that financial institutions' liquidity demand is exceptionally weak. This decision is intended to enable the quantitative easing policy to be conducted more smoothly by making it possible for liquidity to be provided with a minimum of hindrance to the process of price formation and efficient allocation of funds in the financial markets.

In the current situation, the quantitative easing policy contributes to maintaining an accommodative financial environment by stabilizing market interest rates, thus allowing firms to continue to enjoy low funding costs. The commitment's positive effects through interest rates on the economy are strengthening as corporate profits increase with economic recovery.

CONCLUSION

Japan's economy has emerged from its temporary pause and continues to recover. As for the outlook, it is likely to experience a relatively long period of growth, albeit at a moderate pace, and the Bank will continue its close monitoring of developments. At the meeting of general managers of the Bank's branches scheduled for October 20, the Bank will examine the state of the economy in each region thoroughly based on the report presented there.

The Bank will continue to conduct monetary policy appropriately based on careful examination of developments in economic activity and prices. In the current situation where the CPI has been declining slightly on a year-on-year basis, the Bank is determined to support Japan's economy from the financial side to achieve sustainable economic growth with price stability, by maintaining monetary easing in accordance with the commitment based on the CPI.

The Bank will also continue to pursue more advanced central bank services as well as ensure well-disciplined management, according to a Medium-Term Strategic Framework for fiscal 2005–2009 formulated in March 2005, in order to properly carry out the duties entrusted to it as the nation's central bank.

Summary of the *Semiannual Report on Currency and Monetary Control* for the First Half of Fiscal 2005

Economic Developments[1]

1. Japan's economy continued to recover, having emerged from its temporary pause in the first half of fiscal 2005 (April–September 2005).

   Although the momentum of growth in exports to China remained weak through the first quarter of fiscal 2005, exports as a whole continued to increase moderately against the background of the expansion of overseas economies. Industrial production was also on an uptrend with some fluctuations, mainly reflecting the completion of inventory adjustments in IT-related sectors. Business fixed investment continued to increase against the background of high corporate profits. As for the employment and income situation in the household sector, household income rose moderately as the number of employees was increasing and wages had begun to pick up. In this situation, private consumption was generally steady, albeit with some fluctuations.

2. Domestic corporate goods prices continued to increase on a year-on-year basis reflecting the strengthening of commodity prices at home and abroad and the improvement in supply and demand conditions. On the other hand, consumer prices (excluding fresh food) continued to decline slightly on a year-on-year basis generally, partly due to the reduction in electricity and telephone charges.

Financial Developments

3. In the money market, the uncollateralized overnight call rate was stable at extremely low levels of 0.001–0.002 percent generally throughout the first half of fiscal 2005. Interest rates on term instruments were also stable at low levels.

   Long-term interest rates were on a declining trend from the beginning of fiscal 2005 reflecting weaker-than-expected domestic economic indicators and a fall in interest rates in the United States and Europe, falling to a little over 1.15 percent by the end of June. Thereafter they began to rise, albeit with some fluctuations, reaching the 1.45–1.50 percent level, partly in response to improvement in domestic economic indicators and a rise in stock prices.

   The Nikkei 225 Stock Average declined through mid-May, then rose through the end of September, reaching around 13,500 yen for the first time since May 2001, reflecting increased expectations of economic recovery in view of improved domestic economic indicators.

   The yen appreciated to the 104–105 yen level against the U.S. dollar through early May, partly due to increasing expectations for an early revaluation of the renminbi. Thereafter it declined to the 113–114 yen level by the end of September in a situation where market participants were more conscious of interest rate differentials between Japan and the United States as a factor contributing to the appreciation of the dollar.

4. The pace of year-on-year decline in lending by private banks (after adjustment for special items) had been slowing moderately, and from August the year-on-year rate of change in their lending turned slightly positive. The amount outstanding of CP and corporate bonds issued was around or above the previous year's level. The lending attitude of private banks became more accommodative on the whole. The pace of decline in firms' credit demand became somewhat moderate in a situation where the economy continued to recover, although firms continued to reduce their debts.

5. After increasing slightly in April 2005, the year-on-year growth rate of the monetary base (currency in circulation plus current accounts at the Bank) decreased somewhat, and was 1.7 percent in September. The ratio of the monetary base to nominal GDP remained at an extremely high level.

   The year-on-year growth rate of the money stock (M_2+CDs) was generally in the range of 1.5–2.0 percent.

Monetary Policy Meetings (MPMs)

6. Eight MPMs were held in the first half of fiscal 2005.

   In the first half of fiscal 2005, members of the Policy Board revised their April assessment, "Japan's economy continues a recovery trend, albeit with adjustments in IT-related sectors," to "Japan's economy continues to recover, with the progress of adjustments in IT-related sectors" in the summer. In September, the assessment was revised again to "Japan's economy continues to recover,"

1. The semiannual report, which included this summary, was submitted to the Diet in December 2005.

as adjustments in IT-related sectors had almost been completed.

At the MPM on April 28, 2005, members decided the text of the *Outlook for Economic Activity and Prices* (the Outlook Report) for fiscal 2005 and 2006. In the outlook for fiscal 2005 and 2006 in this report, members indicated that Japan's economic recovery was likely to gradually gather momentum from the middle of 2005 as the effects of adjustments in IT-related sectors diminished, and that thereafter the economy was expected to follow a sustainable growth path, albeit at a moderate pace. At the MPM on July 12 and 13, members made an interim assessment in relation to the outlook presented in the Outlook Report released in April. Their assessment was that Japan's economy had been broadly in line with the outlook and was expected to continue to be so.

7. With regard to the conduct of monetary policy, given the above economic and financial developments, members decided to maintain the guideline for money market operations aiming at an outstanding balance of current accounts at the Bank of around 30 to 35 trillion yen at all MPMs during April–September 2005.

At the MPM in May, members decided to add a new sentence to the proviso in the guideline for money market operations, stating that when it was judged that liquidity demand was exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there might be cases where the balance of current accounts temporarily fell short of the target. This decision was made in view of the fact that undersubscription, where financial institutions' bids fell short of the Bank's offers, had occurred frequently in the Bank's funds-supplying operations in a situation where, as concern about financial system stability was abating, financial institutions were feeling more strongly that there was an abundance of liquidity in financial markets.

The Bank's Balance Sheet

8. As of the end of September 2005, the Bank's balance sheet increased by 6.2 percent from the previous year to 148.1 trillion yen.

Toward a New Path of Growth for the Japanese Economy

Speech Given by Toshihiko Fukui, Governor of the Bank of Japan

INTRODUCTION[1]

Semiannually in April and October, the Policy Board of the Bank of Japan decides the text of the *Outlook for Economic Activity and Prices*, or the Outlook Report as we call it, and releases it. This report describes the Bank's outlook for economic activity and prices which provides the basis for conducting monetary policy, and also explains the Bank's thinking behind its conduct of monetary policy. Today I would like to focus on the October 2005 Outlook Report, which was published two weeks ago.

Recent Economic Developments and the Outlook for Economic Activity

Japan's economy continues to recover, having emerged from the temporary pause that began in the summer of 2004. The adjustments in production and inventory in IT-related sectors, which triggered the temporary pause, appear to have run their course, and domestic private demand, such as business fixed investment and private consumption, has been stronger than expected. According to the Cabinet Office's reference dates of business cycles, the economy has been expanding since the beginning of 2002, that is to say, for almost four years now.

Although a V-shaped recovery is unlikely to ensue after the economy's recent emergence from its temporary pause, it is expected to achieve solid growth at a moderate and sustainable pace. The Bank's projection for a period of one and a half years ahead, that is, through the end of fiscal 2006, is that the economy is likely to experience a sustained period of expansion at a pace slightly above its potential. The Bank's main purpose in releasing the Outlook Report is to explain its thinking on the underlying mechanisms of economic activity and prices, and the Policy Board members' forecasts are also provided as reference figures. In the October Outlook Report, the Policy Board members forecast a real GDP growth rate for fiscal 2005 of slightly above 2.0 percent and for fiscal 2006 of around 1.5–2.0 percent. If the economy performs as projected in the October Outlook Report, it will have been expanding at a pace above its potential for a very long period of time, since the actual growth rates for fiscal 2003 and 2004 have been around 2.0 percent, exceeding the Bank's estimate of a potential growth rate of around 1.0 percent.

This outlook for economic growth rests on the following underlying mechanisms. Exports are likely to remain on the increase reflecting the continuing expansion of overseas economies, and against this background, the corporate sector is likely to continue to show strength, and the positive effects of strong corporate performance will steadily exert an influence on the household sector—in other words, economic growth will be led by domestic and external demand that are well in balance. Furthermore, the extremely accommodative financial conditions are likely to support private demand.

What is notable is that domestic private demand, especially business fixed investment and private consumption, is likely to remain strong. The context behind this is that the adjustment pressures in the corporate sector and the financial system that have been hindering the Japanese economy from achieving a sustainable growth path since the bursting of the economic bubble have mostly dissipated. Specifically, in the corporate sector, firms have almost resolved the excess in debt, employment, and production capacity—the "three excesses." As for the financial system, the nonperforming-loan (NPL) problem, which has placed downward pressure on the economy together with these three excesses, has nearly been resolved.

Diffusion indexes for production capacity and employment conditions in the September 2005 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) are at the level of 1992, immediately after the bursting of the economic bubble, showing that adjustments in the excesses have made much progress. In particular, the number of firms perceiving their holdings of labor as insufficient exceeded the number perceiving them as excessive, implying that firms are starting to see themselves as short of labor. Firms have also substantially reduced their interest-bearing liabilities, as evidenced by the marked decline in the ratios of outstanding debt to total assets and to sales not only at large firms but also small and medium-sized firms in the last few years.

While making adjustments in the three excesses, firms have been reviewing their business lines based on the principle of "selection and concentration" and improving their ability to generate high-value-added

1. This article is excerpted and translated from a speech given by Toshihiko Fukui, Governor of the Bank of Japan, to the Kisaragi-kai meeting in Tokyo on November 11, 2005.

products and services as they face intensified global competition. As a result, their profitability has improved greatly. According to the *Financial Statements Statistics of Corporations by Industry*, current profits of Japanese firms have increased for three consecutive years from fiscal 2002, with both profits and the ratio of current profits to sales for fiscal 2004 exceeding those during the height of the bubble era. Despite the headwind of a surge in crude oil prices, corporate profits are likely to continue on an uptrend in fiscal 2005.

Given the high corporate profits, business fixed investment has been increasing steadily in a wide range of industries and is also expected to continue increasing. In the *Tankan* survey, business fixed investment plans of large manufacturers for fiscal 2005 showed a double-digit increase for the second consecutive year, and small and medium-sized firms are also revising their plans upward. As a result, business fixed investment is expected to increase for the third consecutive year for firms of all sizes in all industries.

The strength of the corporate sector is steadily spreading to the household sector. In particular, improvements in the employment and income situation are becoming noticeable. Firms have been placing priority on restraining labor costs, but their stance on employment is becoming positive with the problem of excessive holdings of labor in the corporate sector nearly resolved. One notable example suggesting a change in firms' stance on employment is that the ratio of part-time workers to regular employees, which had been generally on an uptrend since the bursting of the economic bubble, has started to decline. With respect to wages, summer bonus payments have recorded relatively high increases, and regular compensation has started to increase very slightly due partly to the peaking out of the ratio of part-time workers. Supported by the improvement in the employment and income situation, employee income is likely to continue to increase moderately, and against this background, private consumption is expected to continue to rise steadily. Although private consumption has been somewhat weak since the summer, it should be regarded as a reaction to the strong developments in the first half of 2005 and it is likely that this weakness will be temporary, given that positive influences from the corporate sector to households are spreading steadily via increases in employee income.

There have also been remarkable improvements in the financial system. The NPL problem, which has long been a burden on the Japanese economy, has generally been resolved. The amount outstanding of NPLs at major and regional banks has been decreasing since reaching its peak at the end of fiscal 2001, and due mainly to the resulting decline in credit costs, their earnings for fiscal 2004 were the highest in recent years. Net income turned positive in fiscal 2004, for the first time since fiscal 2000 at major banks and since fiscal 1994 at regional banks. Against the background of improvements in profitability and capital adequacy ratios, financial institutions' lending attitude has become more accommodative. Bank lending, excluding the effects of marketing of loan assets and disposal of NPLs, has turned positive on a year-on-year basis since this August, after a prolonged decrease. Financing in capital markets through, for example, issuance of CP and corporate bonds has also been favorable for firms. In this situation, firms' perception of their financial positions has improved to the level of the early 1990s. Such accommodative financial conditions seem to be contributing to the recent increases in housing investment as well as business fixed investment by small and medium-sized firms. These accommodative financial conditions are likely to support private demand.

Pace of Recovery

Japan's economy is likely to continue to expand against the background I have just explained. As I mentioned at the beginning of this speech, the pace, however, is expected to be moderate with less likelihood of acceleration. The main reason for this is the cautiousness of corporate behavior, which is expected to persist.

It seems that firms have still not become confident about the future, having come through a protracted period of low economic growth following the bursting of the economic bubble. Relative to the record-high level of profits that firms have been posting, the improvement in business sentiment, according to, for example, the *Tankan* survey, is only moderate. Although business fixed investment has been increasing, it still remains substantially below the level of cash flow, and firms are reluctant to aggressively increase fixed investment by raising the funds through bank loans or capital markets. While an increasing number of firms are making more efficient use of cash flow since they have nearly completed paying back their excess debt, they still appear cautious about accelerating inventory and capital investments in response to increases in sales and production.

As a result of such corporate behavior, economic recovery is likely to remain moderate but at the same time excessive build-up of stocks is unlikely. The current economic recovery, which is already the third longest in the post-World War II period, is likely to be sustained for this reason.

Positive and Negative Deviations

Japan's economy is expected to continue to recover supported by strength in both the corporate and household sectors with adjustment pressures that have lingered since the bursting of the economic bubble dissipating. Under these conditions, it is unlikely that the economy will fall into recession due to domestic factors, although with globalization, Japan's economy could be adversely affected in the event of a major external shock, for example, a slowdown of the global economy. It is therefore necessary to pay attention to the path of the global economy, as this could pose a downside risk to Japan's economy. In particular, developments in crude oil prices, which continue to be high, and a possible shift from the current accommodative financial conditions observed globally require close monitoring.

Overseas economies, in particular the U.S. and Chinese economies, are likely to continue to expand. The International Monetary Fund (IMF) also expects a high rate of world economic growth, forecasting 4.3 percent real growth both in 2005 and 2006, even though the figure falls short of 5.1 percent, a historic high marked in 2004. Although the growth of the U.S. economy is expected to slow temporarily due to the effects of hurricanes, it is expected to basically continue to expand at a pace around its potential growth rate, partly since there is likely to be reconstruction-related demand. As for the Chinese economy, inventory adjustment has been in progress mainly in sectors related to domestic demand since the second half of 2004 in response to the government's measures to rein in the overheated economy. However, inventory adjustment pressures are likely to taper off in the face of robust economic growth.

Despite the ongoing global economic expansion, there is recently increased awareness of downside risks stemming from the surge in crude oil prices. So far, the global economy has continued to expand despite the record-high level of crude oil prices. A number of factors have contributed to this development. First, one of the primary factors of the surge in crude oil prices is increased global demand, reflecting developments such as high growth in emerging economies, and there is little influence from supply-side constraints. Second, a mechanism of income reflow from oil-producing to non-oil-producing countries is operating. The third and the most important factor from central bankers' viewpoint is that the rise in crude oil prices has not led to a sharp rise in inflationary expectations, and thus monetary policy has not been tightened aggressively. This is because inflationary expectations have been contained as a result of the intensified global competition accompanying emerging economies' transition to a market economy, and central banks have been taking appropriate monetary policy measures.

Long-term interest rates in the United States and other major industrial countries have not yet shown any clear upward movement compared with two years ago when crude oil prices started to rise and a year and a half ago when the Federal Reserve started to raise the federal funds rate target. The coincidence of surging oil prices and relatively low long-term interest rates in a climate of stable economic expansion is hard to explain on the basis of past experience. A growing sense of a surfeit of funds in the economy stemming from the slack in the global balance between savings and investment and the increase in investment in long-term bonds by institutional investors, such as pension funds, have been cited as factors. However, since long-term interest rates basically reflect the market's outlook for economic activity and prices, the fact that inflationary expectations have been contained has greatly contributed to the stability in the rates.

The maintenance of accommodative financial conditions has played a crucial role in the global economic expansion. This is evident in the United States in particular, where stability in long-term interest rates, by causing a continued rise in housing prices, has led to buoyant spending by households through the wealth effect, and this in turn has been supporting economic expansion. Should there be unexpected changes in monetary accommodation in light of rising inflationary expectations caused by, for example, a further rise in crude oil prices, not only would growth in advanced economies slow but the global economy including emerging economies could also be adversely affected, perhaps via a shift in the international flow of funds.

So much for downside risks: let us now look at upside potentials. The domestic view of the outlook for the Japanese economy tends to be pessimistic, due probably to the experience of low growth that lasted for more than a decade. The view held overseas, however, has become increasingly optimistic, with the October 8 issue of *The Economist* carrying a feature titled “The sun also rises.” In fact, firmness in Japanese stock prices since this summer owes significantly to the active investment by foreign investors. As for the Bank’s outlook, it assumes that corporate behavior will generally remain cautious. However, with the three excesses having run their course, and the marked progress in restructuring corporate balance sheets, it is probable that firms will become more confident about the economic outlook as the economic recovery continues. In that case, firms, supported by accommodative financial conditions, are likely to increase business fixed investment and hiring. Under such circumstances, if there are stronger positive influences from the corporate sector to households via increases in employee income, household spending may increase further. These developments would entail an acceleration of economic recovery.

Developments in asset prices such as stock prices and land prices reflect people’s perceptions about the economic outlook. Asset prices are determined based on future cash flow expected to be generated, and they therefore contain important information about people’s view of the future. Recently, stock prices have been strong, and land prices in some parts of Tokyo and other major metropolitan areas have started to rise, suggesting an upturn in people’s expectations regarding the economy. However, land prices on the whole continue to be on the decline. Thus, not all asset prices are increasing, reflecting continuing caution in people’s perception of the outlook. Since developments in asset prices reflect changes in people’s perceptions as well as influence investment activity of firms and households, they require close attention.

Outlook for Prices

Given this economic outlook, the environment influencing prices is likely to change gradually.

The output gap is expected to continue narrowing moderately as the economy continues to recover. Firms’ and households’ expectations regarding prices play an important role in the formation of prices via, for example, firms’ price setting stance. Various survey results show that the number of respondents perceiving that prices will rise in the future has been increasing gradually since hitting bottom in 2001–02.

The consumer price index (CPI; excluding fresh food) has been decreasing on a year-on-year basis since the middle of 1998 for more than seven years now. Recently, however, the pace of decline has slowed considerably, with a 0.1 percent decline in September year on year. As the effects of special factors such as the decline in rice prices and the reduction in electricity and telephone charges fall off, the year-on-year changes in the CPI are likely to turn positive toward the end of 2005. Thereafter, in this environment, the year-on-year changes are expected to remain positive. Forecasts of the majority of Policy Board members for the CPI in fiscal 2006 are between 0.4 and 0.6 percent on a year-on-year basis.

Despite the fact that the economy has been growing at a pace above its potential since fiscal 2003, over two years now, and the output gap continues to improve, the impact on prices has remained small. This is mainly because the decline in unit labor costs—labor costs per unit of production of goods and services—which was brought about by a decline in wages and a rise in productivity worked to contain upward pressure on prices. Unit labor costs are unlikely to record a clear increase in the near future because the rise in productivity will still tend to hold them down despite the increases in wages. In this situation, it is unlikely that the pace of increase in prices will accelerate.

The impact of economic activity on prices has been weakening, and this has been a global phenomenon. However, it is uncertain whether this will continue in the future. A sustained narrowing of the output gap may cause a greater-than-anticipated increase in inflationary expectations. This can prompt firms to pass increases in costs, for example, a rise in input prices, on to sales prices. Although it is most likely that the rise in prices will be contained, the risk of an upward deviation in prices should nevertheless be kept in mind.

Conduct of Monetary Policy

It has been four and a half years since the Bank first introduced the framework of the quantitative easing policy. This policy is unprecedented not only in the history of Japan but anywhere in the world. In the spring of 2001, Japan faced an economic deterioration and a decline in prices, and concerns about financial system stability intensified. With regard to monetary policy, short-term interest rates were already practically zero percent and the Bank could not reduce them further. In response to this situation, the Bank introduced the current quantitative easing policy framework, which has two pillars: provision by the Bank of ample liquidity to the money market so that the outstanding balance of current accounts at the Bank exceeds the amount of required reserves; and a commitment by the Bank to continue with this ample provision of liquidity until the year-on-year rate of change in the CPI (excluding fresh food) registers zero percent or higher on a sustainable basis.

When there were strong concerns over the stability of the financial system, the Bank's ample provision of liquidity, which met financial institutions' liquidity demand, stabilized financial markets and maintained accommodative financial conditions, and thus contributed to averting a contraction in economic activity. This was the case in 2001–02 when the disposal of NPLs at major banks reached its peak and the partial removal of blanket deposit insurance drew near, and in 2003 when public funds were injected into Resona Bank. The commitment by the Bank, together with market participants' expectations for consumer prices, has led them to expect that short-term interest rates will remain at zero percent for some time, and as a result longer-term interest rates have remained stable at low levels. The quantitative easing policy has thus been contributing greatly to the recovery in Japan's economy through the Bank's provision of ample liquidity and its policy commitment.

The effects of the quantitative easing policy have been changing with developments in economic activity and prices as well as the state of the financial system since its introduction. With regard to the effects of ample liquidity provision by the Bank, an effect of reducing very short-term interest rates to practically zero percent remains unchanged. However, as described earlier, with the progress in the disposal of NPLs, precautionary demand for liquidity has declined substantially, reflecting diminishing concerns over financial system stability. The effects of the policy commitment by the Bank have also been changing. In principle, the expected duration of the quantitative easing policy based on the Bank's commitment can either lengthen or shorten depending on market participants' expectations for prices. With more market participants recently expecting that the year-on-year rate of change in the CPI will be a positive figure in the near future, the duration of the policy as expected by market participants is shortening. As a result, the policy commitment is gradually losing its influence on the formation of longer-term interest rates. This is a natural consequence considering the characteristics of the commitment.

As a result of the above changes, the stimulative effects of the quantitative easing policy on economic activity and prices are at present increasingly coinciding with the effects of short-term interest rates being at practically zero percent.

As for a change of policy framework, the Bank will judge whether the policy commitment has effectively been fulfilled, in other words, whether the year-on-year rate of change in the CPI is registering zero percent or higher on a sustainable basis, by monitoring economic activity and price developments. Assuming that economic activity and price developments follow the projection described in the October Outlook Report, the possibility of a departure from the present monetary policy framework is likely to increase over the course of fiscal 2006. We cannot tell exactly when the Bank will actually change the framework, since it depends on future economic and financial developments. In any case, the Bank will appropriately determine the timing in view of these developments.

Such a change of framework would mean a reduction in the outstanding balance of current accounts at the Bank toward a level in line with required reserves, and a shift in the main operating target for money market operations from the outstanding balance of current accounts to short-term interest rates. At present, the effects of the quantitative easing policy are increasingly coinciding with the effects of short-term interest rates being at practically zero percent. Thus, a change of policy framework itself does not imply an abrupt change in terms of effects of policy. There will then be a period of very low short-term interest rates followed by a gradual adjustment to a level consistent with economic activity.

Conceptually, the course of monetary policy after the change of framework will be a reduction in the outstanding balance of current accounts, a period of very low short-term interest rates, and a gradual adjustment to a level consistent with economic activity.

How exactly the Bank will proceed, in other words, how the Bank will reduce the outstanding balance of current accounts and set the level and time path of short-term interest rates thereafter, will depend on future developments in economic activity and prices as well as financial conditions. In this regard, if it is judged that upward pressure on prices continues to be contained and the economy follows a sustainable and balanced growth path, this is likely to give the Bank latitude in conducting monetary policy through the entire process. Based on this, I would like to point out two things.

First, when reducing the outstanding balance of current accounts, the Bank will need to monitor financial market conditions carefully. With the Bank's quantitative easing policy, financial institutions have for a long period of time been conducting their financing based on the existence of the large current account balance at the Bank. Although the functioning of the money market will recover eventually, investment and raising of funds in financial markets may be hindered for a while after the change of framework.

And second, it is essential to ensure that financial markets are able to perform the pricing function smoothly, reflecting underlying economic and price conditions. The markets in principle perform the function of envisaging future monetary policy based on economic and price conditions and also perform the function of forming interest rates. However, given that there is no precedent for a change from the current policy framework to another, it is important for the purpose of smooth formation of interest rates that the Bank clearly explain its assessment of economic activity and prices as well as the thinking behind the conduct of monetary policy, and endeavor to stabilize market expectations. In order to realize sustainable economic growth and stable prices, the Bank will take measures in an appropriate and timely manner in response to economic and financial developments.

CONCLUSION

I have talked mainly about the content of the October Outlook Report as well as expected developments in Japan's economy and the thinking behind the conduct of monetary policy. The economy is on the threshold of a new path of growth, after an adjustment process lasting over ten years since the bursting of the economic bubble. The Bank will continue to conduct monetary policy appropriately and support this growth from the financial side.

Speech by Toshihiko Fukui, Governor of the Bank of Japan

At a Meeting with Business Leaders in Nagoya on December 8, 2005

INTRODUCTION[1]

I understand that this has been a very active and full year here in the Chubu region with the opening of Central Japan International Airport (Centrair) and the success of Expo 2005 Aichi Japan. The Japanese economy has also been recovering its vibrancy, as if absorbing the dynamism of your region. I attended the meeting of the G-7 countries in London last week. The G-7 countries shared the view that overall global economic growth remained and should continue to be solid although there were risk factors such as high crude oil prices and increasing inflationary pressures. In my remarks today, I will present the Bank's view regarding recent economic and financial developments, and explain our thinking on the conduct of monetary policy.

The Current State of Japan's Economy and the Outlook

Japan's economy continues to recover, having emerged from the temporary pause that began in the second half of 2004. The economy is likely to experience a sustained period of expansion at a pace slightly above its potential. The Bank released the October *Outlook for Economic Activity and Prices* (the Outlook Report) about a month ago. This Outlook Report projects that such economic growth will continue during the rest of fiscal 2005 and through fiscal 2006.

In addition to the continued expansion of overseas economies, another major factor behind the ongoing recovery is that the corporate sector has essentially completed its adjustments of the "three excesses," namely, production capacity, employment, and debt. In relation to the financial system, it may also be noted that financial institutions have now mostly overcome the nonperforming-loan (NPL) problem and recovered their management stability.

In the corporate sector, corporate profits have increased for three consecutive years since fiscal 2002, and this trend is continuing during fiscal 2005 with the ratio of profits to sales primarily at large firms surpassing the levels recorded during the bubble era. The semiannual book closings for the first half of fiscal 2005 indicated that high profits were being maintained across a wide range of industries. As a background to the favorable corporate profits over the past three to four years, firms have reduced the "three excesses," and this has been effective in greatly lowering break-even points. Amid these developments, the global economic growth rate accelerated through 2003–04, and domestic private demand has been firmer than predicted in fiscal 2005, pushing up sales and strongly supporting the recent improvement in profits.

Domestic private demand has been firmer than expected because while business fixed investment has increased against the background of high corporate profits, strong corporate performance is positively influencing the household sector via increases in wages and employment, as well as increases in dividends and stock prices. According to the *Tankan* (Short-Term Economic Survey of Enterprises in Japan), large and small firms believe that they are presently facing their greatest personnel shortages in 13 and eight years, respectively. Under these conditions, the number of part-time employees peaked in early fiscal 2005 and the number of full-time employees is growing. Turning to wages per worker, regular payments have been rising, mostly because of increases in wages for full-time employees, and special payments have also been increasing against the background of high corporate profits. According to surveys by private institutions, winter bonuses at large firms for 2005 will increase at a high rate, surpassing the rise in summer bonuses. Consequently, household income continues to rise gradually. Moreover, the dividend income received by households is growing year by year, with the percentage of dividend income against interest income rising from about 40 percent to about 80 percent over the past three to four years. Amid this improvement in the employment and income situation, consumer confidence is generally good and private consumption has been steady.

In this manner, a virtuous cycle has begun whereby favorable corporate profits are leading to stronger business fixed investment and spreading to the household sector in various ways, increasing household expenditures and feeding back to the corporate sector via the growth in private consumption. The economy is thus unlikely to fall into a recession due to domestic factors for the time being.

Also, as I have mentioned, the financial system has been improving significantly. The percentages of NPLs at financial institutions have declined greatly

1. This article is excerpted and translated from a speech given by Toshihiko Fukui, Governor of the Bank of Japan.

since they peaked at the end of fiscal 2001, and banks posted record-high profits in their semiannual book closings at the end of September 2005, surpassing those achieved during the bubble era. Bank lending (amount outstanding, after adjusting for the liquidation of loans and loan write-offs), which had long maintained negative growth, began to rise year on year from August 2005. While the corporate sector as a whole continues to repay debt, repayment pressures are gradually easing, and amid the continuing recovery in business conditions some firms are moving ahead with their external funding activities, taking advantage of the accommodative financial environment. Additionally, land price adjustments have advanced, especially in major cities, and the increase in housing-related investment, among others, is another factor contributing to the rise in bank lending.

Future Risk Factors

Of course, there are certain risk factors for the economic outlook. The Bank is paying particular attention to the rise in crude oil prices and the developments in overseas economies. Crude oil prices marked a record high around the end of August 2005 (about 70 U.S. dollars/barrel for WTI crude oil) following the hurricane damage in the United States, and have softened somewhat recently, but remain at a rather high level. The rises in crude oil prices in recent years are largely attributable to increased global demand, reflecting developments such as high growth in emerging economies. Therefore, high crude oil prices may be compatible with the expansion of the global economy if both oil-producing countries and oil-consuming countries take adequate actions to deal with increased demand. Nevertheless, as demonstrated by the rapid increase in crude oil prices with the U.S. hurricane damage through the end of August, there is some risk that crude oil prices may shoot up to a level that is not compatible with the demand increase accompanying the expansion of the global economy when there is a keen awareness that refining capacity and other supply constraints are intensifying. If that risk manifests in the future, it may influence the global economy and the economy of Japan by further decreasing the real purchasing power of the non-oil-producing countries and by the full-scale emergence of global inflationary concerns.

As for overseas economies, price stability is being maintained in the United States as the Federal Reserve has raised interest rates to prevent the emergence of inflationary pressures while crude oil prices remain at a high level. In Europe and Asia, concern is shifting toward the risks on the inflationary side. The European Central Bank raised interest rates at the beginning of December 2005. The maintenance of an accommodative financial environment under price stability forms part of the background to the expansion of overseas economies in recent years, and a future loss of price stability could change this structure and exert a negative influence on the growth of the global economy. While I mentioned before that the Japanese economy is unlikely to fall into a recession due to domestic factors, we must note that an unexpected slowdown in overseas economies or other large external shocks could decelerate economic growth in Japan.

Price Conditions and the Outlook

Turning to price conditions, domestic corporate goods prices are currently rising at a pace slightly below 2 percent year on year, reflecting the increase in crude oil and other international commodity prices and the depreciation of the yen. While the rate of increase is likely to ease, corporate goods prices are projected to continue rising with strong upward pressure.

The consumer price index (CPI; excluding fresh food, on a nationwide basis) had been moving slightly below the previous year’s levels, but posted a zero percent rise from 2004 in the recently released figures for October 2005. The CPI figures for January through March 2006 are expected to show relatively clear positive year-on-year increases. This is affected by the factors that the negative contribution from lower rice prices has dissipated and the influence from electricity and telephone charge reductions is weakening. In addition, it is affected by the factors that the decline in unit labor costs is shrinking under rising wages, and the gap between supply and demand is narrowing in the Japanese economy as a whole, as indicated by the perceptions of a labor shortage in the *Tankan*. The year-on-year changes are expected to remain positive thereafter as Japan’s economic growth is projected to exceed the potential growth rate. Surveys on price developments also indicated that expectations of prices were being revised upward.

Financial Market Developments

Against this background of a positive turn in the outlook for economic activity and prices, net purchases of Japanese stocks by foreign investors have been posting record highs, stock prices have risen substantially, and the Nikkei 225 Stock Average recovered the 15,000 yen level at the beginning of December 2005, the highest level in about five years. Meanwhile, the yen has depreciated further in the foreign exchange market, falling to 121 yen to the U.S. dollar in early December and continuing its declining trend against the euro and Asian currencies. It is said that the recent depreciation of the yen reflects market participants' view on differentials between Japanese and foreign interest rates, given the greater awareness of inflation risk abroad and heightened expectations of higher interest rates. The influence on the economic activity and prices from these financial market developments including the rise in stock prices continues to warrant careful monitoring.

The Bank's Conduct of Monetary Policy

The Bank has been maintaining the quantitative easing policy since March 2001. The two pillars of the quantitative easing policy are: the Bank's provision of ample liquidity to the money market so that the outstanding balance of current accounts at the Bank substantially exceeds the amount of required reserves of about 6 trillion yen; and the Bank's commitment to continue with this provision of ample liquidity until the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) registers zero percent or higher on a sustainable basis. This commitment is unprecedented as central bank monetary policy, but stipulating the conditions beforehand has made it possible for market participants to act based on the commitment and that has contributed to boosting the transparency and effectiveness of monetary policy.

Reviewing the subsequent policy effects, when there were strong concerns about financial system stability, the provision of ample liquidity by the Bank, which met financial institutions' liquidity demand, stabilized financial markets and maintained accommodative financial conditions, and contributed to averting a contraction in economic activity. In financial markets, the Bank's provision of ample liquidity pushed short-term interest rates down to practically zero percent. Longer-term interest rates have remained stably at low levels, because the commitment by the Bank has led the market to expect that the short-term interest rates will remain at zero percent when prices continue to decline.

Now that concerns about financial system stability have subsided substantially and prices are beginning to rise, the commitment is losing its influence on the formation of longer-term interest rates. Thus, the effects of the quantitative easing policy are coinciding with the effects of short-term interest rates being at practically zero percent.

After the quantitative easing policy is maintained in accordance with the commitment, future monetary policy will follow the path of the processes of "reducing the outstanding balance of current accounts toward a level in line with required reserves," "maintaining very low interest rates," and "gradually adjusting interest rates to a level consistent with economic activity and price developments."

In explicating these processes in somewhat greater detail, with respect to the timing for changing the quantitative easing policy framework, the Bank will judge whether the year-on-year rate of change in the CPI registers zero percent or higher on a sustainable basis in accordance with the commitment. Assuming that developments follow the projection described in the Outlook Report, the possibility of meeting the conditions of the commitment and of departing from the present monetary policy framework is likely to increase over the course of fiscal 2006.

In reducing the outstanding balance of current accounts, the Bank will need to monitor financial market conditions carefully, because the outstanding balance of current accounts at the Bank has been exceeding substantially the amount of required reserves for a long period of time.

Up to this point, the outstanding balance of current accounts, substantially above the level of required reserves, has kept very short-term interest rates practically at zero percent, with some minor fluctuations if any. Considering that the effects of the quantitative easing policy are coinciding with the effects of short-term interest rates being at practically zero percent, a change of the policy framework itself does not imply any major change in the policy effect. If the trend toward positive year-on-year growth in the CPI becomes firmly established, real short-term interest rates will effectively decline, providing powerful stimulus to economic activity and prices.

The level and the time-path of interest rates under the subsequent two processes will certainly depend on economic activity and price developments. If it is judged that upward pressure on prices continues to be contained and the economy follows a sustainable and balanced growth path, this is likely to give the Bank latitude in conducting monetary policy.

The Bank conducts monetary policy to realize the sustainable growth of the Japanese economy under price stability. At present, the economic recovery is continuing and the environment influencing prices is beginning to change. If the year-on-year rate of change in the CPI registers zero percent or higher on a sustainable basis, that will mark a sort of milestone toward realizing such a goal. The Bank will continue to conduct monetary policy appropriately in accordance with the changes in economic and price conditions to provide support from the financial side for the good performance of the Japanese economy over the long term.

Appropriate monetary policy is also important from the perspective of financial market stability. For example, long-term interest rates have remained stable in the United States in part because of market confidence that the appropriate conduct of monetary policy by the Federal Reserve will maintain price stability into the future. In Japan as well, as noted in the Outlook Report, together with the maintenance of appropriate monetary policy, the Bank's explanation of its thinking on the conduct of monetary policy in detail will contribute to smooth formation of prices in financial markets.

CLOSING REMARKS

Chubu is a region that has taken advantage of its manufacturing strengths, vigorously developed private-sector business activities, and pulled the Japanese economy forward. Such originality and inventiveness based on private-sector initiatives will be of the utmost importance for the Japanese economy to realize sustainable growth. In that sense, I look forward to the further remarkable development of the Chubu region.

The Current Situation and Outlook for Japan's Economy

Speech Given by Toshihiko Fukui, Governor of the Bank of Japan

INTRODUCTION[1]

There is now only one week remaining in 2005. The year has been marked by steady progress toward a new path of growth for Japan's economy, with the completion of adjustments that had been ongoing since the bursting of the bubble. Today, I will focus on the path of Japan's economy in 2006 and onward, talking about the current situation and immediate outlook for economic activity and prices, as well as the challenges facing the economy over the longer term.

Current Economic Situation

Japan's economy has regained its momentum for recovery, having emerged from the temporary deceleration in economic growth from the second half of 2004. Real GDP in the July–September quarter of 2005 has posted positive growth for the third straight quarter. Japan's economy is likely to experience a sustained period of expansion, albeit at a moderate pace.

The current economic expansion has lasted almost four years since January 2002, based on the Cabinet Office's reference dates for business cycles. This already makes it the third longest expansion phase in the post-World War II period, and in the coming year it is appearing increasingly likely to surpass the two other long postwar economic expansion phases, namely the Heisei boom (four years and three months during 1986–91), and the Izanagi boom (four years and nine months during 1965–70).

Japanese stock prices have been increasing in response to the economic recovery. The Nikkei 225 Stock Average recovered to the 15,000 yen level at the beginning of December 2005, its record high for about five years, and even reached the 16,000 yen level temporarily yesterday, December 21. Since the beginning of 2005, the Nikkei 225 Stock Average has risen by more than 30 percent, marking the largest increase among major industrial countries. In the meantime, the net purchase of Japanese stocks by foreign investors has increased substantially.

In analyzing business conditions, differences across regions, industries, and firm sizes should of course be taken into consideration. The Bank of Japan collects information via its network of branches spread throughout the country so as to accurately grasp regional developments. Recent information indicates that most regions in Japan have been recovering, although notable differences remain in the degree of improvement: regions with a concentration of high-tech businesses show strength, while those that are highly dependent on public investment remain in relatively severe circumstances.

Factors behind the Moderate and Sustainable Economic Recovery

As I mentioned earlier, Japan's economy is likely to experience a sustained period of expansion albeit at a moderate pace in 2006. There are several factors underlying this economic outlook.

The first factor is that overseas economies are likely to continue expanding. Japan's exports are expected to continue increasing against the background of this overseas economic expansion.

The second factor is that the corporate sector is finally reaching the end of the long path of the post-bubble adjustments. Firms have almost resolved their "three excesses" in production capacity, employment, and debt. For example, the recently released December *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that both the number of firms perceiving their production capacity to be insufficient and the number perceiving their holdings of labor to be insufficient have simultaneously exceeded the numbers perceiving them to be excessive for the first time since the bursting of the bubble. Furthermore, ratios of firms' outstanding debt to total assets and to sales have been declining not only at large firms but also small and medium-sized firms.

While making adjustments in the "three excesses," firms have responded to economic globalization by reallocating their production bases so as to take advantage of the international division of labor. On the domestic side, they have been reviewing their business lines based on the "selection and concentration" strategy and improving their ability to create high-value-added products and services. As a result, current profits at Japanese firms of all industries and sizes increased for fiscal 2004, with profits and the ratio of current profits to sales exceeding those recorded at the height of the bubble era. Corporate profits are likely to continue to increase for the fourth straight year in fiscal 2005,

1. This article is excerpted and translated from a speech given by Toshihiko Fukui, Governor of the Bank of Japan, to the Board of Councillors of Nippon Keidanren (Japan Business Federation) in Tokyo on December 22, 2005.

while absorbing the cost resulting from high crude oil prices.

Reflecting high corporate profits, business fixed investment is likely to continue to increase across a wide range of industries. According to the December *Tankan*, not only have large manufacturing firms substantially increased their business fixed investment plans for fiscal 2005, but small and medium-sized firms have also steadily revised their plans upward. As a result, business fixed investment is expected to increase for the third straight year for firms of all industries and sizes.

Financial institutions have mostly resolved their nonperforming-loan problems, which are inextricably linked with firms' excessive debt, and financial institutions' profits have been improving markedly. As a result, financial institutions' lending attitude has become more accommodative, and their lending has been recovering. Financing in capital markets through, for example, issuance of CP and corporate bonds has continued to be favorable, indicating that firms' financing demand is being sufficiently met. These extremely accommodative financial conditions are supporting private demand.

The third factor supporting the ongoing economic recovery is the positive interaction which has started to operate between the corporate and household sectors: the positive effects stemming from the increased corporate profits have gradually spread to household income, feeding back to the corporate sector via increased private consumption.

Looking at the employment situation, the number of employees has been increasing since 2004, with the number of full-time employees also increasing recently. Regular payments have been increasing steadily, and winter bonus payments are expected to have registered a steady increase. Moreover, increases in receipts of dividends and wealth effects stemming from higher stock prices have started to contribute to the steady developments in private consumption.

Reflecting the improvement in the employment and income situation, consumer confidence continues to be favorable on the whole and private consumption is likely to remain steady. Housing investment has shown some strength, as evidenced in housing for sale and housing for rent, reflecting low interest rates.

The fourth and last factor supporting the economic recovery, relating back to its moderate pace, is that corporate behavior has remained cautious so that an excessive buildup of stocks, such as production capacity and inventory, is unlikely to occur. The current levels of business fixed investment appear modest relative to the historically high level of current profits. Since cautious corporate behavior will help prevent large economic fluctuations, the economy is likely to experience a sustained period of recovery at a moderate pace.

Uncertainty over the Outlook for Economic Activity

Japan's economy continues to recover steadily and is unlikely to fall into recession due to domestic factors. Nevertheless, in discussing the outlook for Japan's economy, it is necessary to maintain a close watch on the rise in crude oil prices and its impact on developments in overseas economies, including the United States.

Crude oil prices have softened somewhat since marking a record high around the end of August 2005, but they still remain at high levels. The high crude oil prices are mainly due to increased global demand, reflecting the expansion of the global economy. But another factor, highlighted by the two hurricanes that recently struck the United States and revealed supply-side weaknesses, particularly in refining capacity, is the risk that the supply of crude oil will fail to meet growing global demand. If crude oil prices rise further due to supply-side constraints, the global economy will be affected by a decline in real purchasing power in non-oil-producing countries, or by rising concerns over increasing inflationary pressures worldwide.

In the United States, the Federal Reserve has gradually raised the targeted federal funds rate to above 4 percent. Partly due to these monetary policy actions, the rise in the core consumer price index (CPI) has been contained. However, concern about inflationary risks is emerging due to such factors as the surge in crude oil prices. The current U.S. economic growth has been supported by relatively low long-term interest rates, which have been underpinned by well-contained long-term inflation expectations due to the appropriate conduct of monetary policy. Should, however, price stability be undermined and the financial environment become destabilized, not only would growth in the United States slow, but the global economy could also be affected by abrupt changes in the international flow of funds.

Another issue that every country should address in an effort to achieve sustainable global economic growth from a slightly longer-term perspective is increasing global imbalances. At the meeting of the G-7 countries held at the beginning of December in London, the view was shared that each country was taking steps to address these imbalances but more vigorous, mutually reinforcing action was needed.

Developments in Prices

The environment influencing prices has been improving as the economy continues to recover. The output gap is likely to continue narrowing moderately, as the economy continues to recover at a pace slightly above its potential. The decline in unit labor costs is likely to slow along with the increases in wages, despite continued downward pressure from the rise in productivity. Various survey results show that firms' and households' expectations regarding prices are gradually being revised upward.

As for the potential growth rate, some argue that it is higher than previously estimated, and thus that the output gap is unlikely to narrow much. It should be noted, however, that a rise in productivity tends not only to expand production capacity but also to stimulate demand via increases in firms' expected growth and households' expected income. Thus, the overall effect on prices of the rise in the potential growth rate varies depending on how these opposing mechanisms work over time.

The impact of the expansion of emerging market economies on price developments is increasingly significant. It has been pointed out that the expanding production capacity of emerging market economies, particularly China, has been containing upward pressure on prices. Recently, however, attention is also being paid to another aspect of increased production capacity in these economies, namely, the upward pressure being exerted on crude oil and other raw materials prices. Therefore, in assessing underlying price developments, the effect of relative price changes at the global level should be taken into consideration.

Looking at individual price indicators, domestic corporate goods prices are increasing, due mainly to the effects of the rise in crude oil and other international commodity prices and the depreciation of the yen, and they are expected to continue increasing. The year-on-year rate of change in consumer prices (excluding fresh food) had been slightly negative thus far, but posted 0.0 percent in October. The year-on-year rate of change is expected to record a slight increase and remain positive thereafter.

As for the outlook, a reduction in electricity charges and other special factors are likely to exert downward pressure on consumer prices from April 2006, the beginning of the next fiscal year. At the same time, there will be other special factors placing upward pressure on consumer prices, so that the net effect remains uncertain. The Bank, however, thinks it unnecessary to change its view that the year-on-year change in the CPI is expected to remain positive in view of the gradual narrowing of the output gap.

Land prices on the whole continue to decline, but those in some parts of Tokyo and other major metropolitan areas have started to rise. These developments are notable as they suggest a gradual upturn in people's expectations regarding the future course of the economy.

Challenges for the Future: The Declining Population

The Japanese economy continues to recover steadily, as I mentioned. Looking toward the near future, however, Japan will enter an era of population decline as a result of the declining birthrate of its aging society.

According to population statistics, the working-age population (15–64 years old) has already started to decline after peaking in 1995. The total population is projected to peak in 2006, according to the medium variant projection of the National Institute of Population and Society Security Research. It has also been pointed out that the total population is likely to start decreasing earlier than projected.

It is assumed that the decline in population will significantly affect the Japanese economy. Supposing that the labor force participation rate remains unchanged, a decline in the total population will cause a decrease in the labor force population. Without substitution of capital for labor or an increase in the rate of technological progress, this decline in the labor force population will lower economic growth. Focusing on the near future, as the baby-boomers reach retirement age between 2007 and 2009, the trend of a decreasing labor force population may accelerate. With a decreasing total population, an increase in the proportion of the aged may also lower the savings rate and lead to deceleration in capital accumulation.

In spite of the continued decline in the labor force, I would argue that it is quite possible not only to maintain the current level of per capita income but also to realize a new stage of economic development, if technological progress accelerates and/or economic efficiency is improved.

In this regard, economies have the flexibility to respond to demographic changes such as a population decline or population aging. A shortage of labor supply will be at least partly neutralized by increases in the labor force participation rate, induced by, for example, rises in wages. The Japanese industrial structure will change by shifting to capital-intensive industries, transferring the production bases of labor-intensive industries overseas. The Japanese industrial structure will also change in response to the demand for new goods and services accompanying the aging of the population, including nursing care for the elderly.

To enable the economy to respond in this way, some crucial adjustments need to be made to the economic and social system as a result of demographic changes. For example, in response to an increase in average life expectancy, it is important to provide reemployment opportunities for people reaching retirement age, ensuring that they are able to work for a longer proportion of their lives. This viewpoint seems important in addressing the problems relating to the retirement of the baby-boomer generation. Furthermore, in order to increase the labor force participation rate for women, it is important to develop social and working environments conducive to balancing work with family life, including public support for childcare. Efforts to improve these environments are expected to neutralize the decline in the labor force. Meanwhile, on the financial side, initiatives taken by financial institutions to accommodate households' portfolio requirements, which are becoming more diversified due to demographic changes, will contribute to greater risk tolerance.

Another extremely important point is how we improve productivity in the economy. In addition to increasing the flexibility of the economic structure to allocate limited resources more efficiently, it is deemed necessary to expand the frontiers of Japan's economy by encouraging innovation: technological progress, knowledge creation, and the combination of the two. It should be noted that these efforts will contribute not only to strengthening the supply side of the economy, but also to generating sustainable demand. In other words, by using innovation as a lever to reallocate production resources dynamically to growing sectors, the demand and supply sides of the economy may be expected to expand in a mutually complementary manner.

Needless to say, corporate executives, including many of you here today, have already begun to actively engage with these ongoing demographic changes. If, as a result of such efforts, the dynamism of Japan's economy is fully exploited, I think it entirely feasible that the potential of the economy will be enhanced even in the face of a declining labor force.

Conduct of Monetary Policy

In closing, let me touch upon the Bank's conduct of monetary policy.

The Bank's monetary policy is aimed at contributing to the balanced and sustainable growth of Japan's economy through the pursuit of long-run price stability.

As for the conduct of monetary policy in the near future, the Bank will aim to achieve its stated goal by maintaining the framework of the quantitative easing policy based on the clear commitment in terms of the CPI. With the economic recovery likely to remain highly sustainable and the year-on-year changes in the CPI expected to remain positive, the possibility of a departure from the unprecedented framework of the quantitative easing policy, which was introduced to stave off a deflationary spiral, is likely to increase over the course of fiscal 2006. In making this decision, the Bank will judge whether the policy commitment has effectively been fulfilled, that is, whether the year-on-year rate of change in the CPI is registering zero percent or higher on a sustainable basis, by monitoring developments in economic activity and prices.

Since, at present, the effects of the quantitative easing policy are increasingly coinciding with the effects of short-term interest rates being at practically zero percent, a change of the policy framework does not in itself imply any major change in policy effects. Such a change is likely to encourage smoother formation of the yield curve in financial markets, thereby invigorating the economy. Although the level of interest rates after such a change of policy framework will of course depend on developments in economic activity and prices, an accommodative financial environment is likely to be maintained, as long as upward pressure on prices continues to be contained and the economy follows a sustainable and balanced growth path.

CONCLUSION

Japan's economy is now entering a robust recovery phase, having gone through an adjustment period of more than a decade since the bursting of the bubble. Structural reform of the economy is aimed at stimulating activity in the private sector while managing the economy in a more market-oriented manner. Thanks to deregulation and other government policy measures and private-sector initiatives, the economy is on the threshold of a new growth phase. It is important to make the best of private-sector dynamism by establishing clear prospects for fiscal consolidation while at the same time gaining credibility among the public.

The Bank is determined to contribute to the new growth phase of Japan's economy, through its efforts to achieve long-run price stability by the appropriate conduct of monetary policy.

Price Stability and Central Banks' Responsibility

Speech Given by Toshiro Muto,
Deputy Governor of the Bank of Japan

INTRODUCTION[1]

Japan's economy continues to recover, having emerged from the temporary pause that began in the summer of 2004. According to the Cabinet Office's reference dates of business cycles, the economy has been in an expansionary phase since the beginning of 2002, for almost four years now. The economy is likely to continue to show moderate and sustainable growth in the future. As for prices, the year-on-year rate of decline in the consumer price index (CPI; excluding fresh food, on a nationwide basis) had widened to as much as around 1 percent in the past, but the October figure released last week was same as the previous year's level. The year-on-year changes in the CPI are likely to be slightly positive toward the end of 2005, and thereafter they are expected to remain positive with a continued economic recovery. In view of these developments in economic activity and prices, I would like to go back to the basics and talk about the following: why central banks pursue price stability; and how they work to achieve price stability.

Why Is Price Stability Necessary?

Central Banks and Price Stability

Price stability is the most important goal of monetary policy for central banks in advanced economies. In the Maastricht Treaty establishing the European Union, the primary objective of monetary policy of the European Central Bank (ECB) is stated as maintaining "price stability." In the United States, although the three objectives of the Federal Reserve's monetary policy are stipulated as promoting "maximum employment, stable prices, and moderate long-term interest rates" in the Federal Reserve Act, there seems to be a broad consensus that achieving the objective of "stable prices" will help attain the other two objectives. In Japan, it is clear that the Bank of Japan's monetary policy is also aimed at price stability—the Bank of Japan Law, which came into effect on April 1, 1998, states that monetary policy is "aimed at, through the pursuit of price stability, contributing to the sound development of the national economy."

Signaling Function of Relative Prices

Why do central banks pursue price stability? I would like to start by defining the term "prices." As consumers, we all purchase various goods and services. Firms also trade various types of goods and services with other firms. A composite of prices of individual goods and services is referred to as "prices" or "general prices," as opposed to individual prices. Stable general prices do not of course mean that all prices of individual goods and services are constant. With the mechanism of a market economy, prices of individual goods and services fluctuate reflecting their supply and demand conditions. As a result, the relative relationship between prices of individual goods and services will also alter and this is usually referred to as a change in "relative prices," as opposed to a change in "general prices."

"General prices" measures how much the price of a basket of goods and services rises. When general prices are flat, a change in "individual prices" is a change in "relative prices." It is this change in relative prices that enables consumers and firms to decide which goods and services to buy as well as judge which one is sold the most and where new business opportunities lie. It is consumers' and firms' decision making based on changes in relative prices that makes possible the efficient allocation of resources. This role performed by relative prices is called their signaling function. Once stability in general prices falls apart, this function of relative prices will be seriously damaged. This is because it becomes difficult to determine what is causing individual prices to move: whether it is fluctuations in "relative prices" reflecting supply and demand conditions of individual goods and services; or whether it is fluctuations in "general prices." Therefore, in order to allocate resources effectively and thus drive the economy to perform in such a way as to fulfill its potential to the maximum, via rational and timely decision making by consumers and firms, it is important for the signaling function of relative prices to operate fully. And stability in general prices, in other words "price stability," is indispensable as a prerequisite for the signaling function of relative prices to operate fully.

Effects of Price Changes on Income Distribution

With the continuing high rate of increase in prices after the first oil crisis, employees demanded large pay raises and firms proactively raised prices of goods and services in anticipation of a rise in the cost, both

1. This article is excerpted and translated from a speech given by Toshiro Muto, Deputy Governor of the Bank of Japan, to the Keizai Club in Tokyo on December 2, 2005.

of which caused the increase in prices to accelerate further. As can be seen from this experience, a continued surge in prices not only increases uncertainty about future price developments and makes it difficult for people and firms to make rational decisions but also causes an unexpected income transfer. For example, the amount of credit/debt in an ordinary financial transaction such as lending/borrowing of funds is paid/repaid at the fixed nominal value. Therefore, an increase in prices will cause the lender to incur a loss by reducing the real value of the principal and the interest received, whereas it will benefit the borrower by reducing the real value of the debt. Such losses and gains also arise in other types of contracts to make payment in the fixed nominal value such as a wage contract. This does not occur in a contract which factors in a possible future rise in prices, such as one that allows payment or repayment to be adjusted in accordance with movements of prices. However, it is difficult in fact to make this type of contract for all financial transactions, and thus it is inevitable that the real value of credit/debt will change due to price movements, which will eventually cause a distortion in income distribution. If these effects of price movements become strong, they may impede smooth transactions in financial and other markets and damage people's faith in social justice, which will adversely affect efficiency of resource allocation and economic growth in the medium to long term.

Problems Encountered When Prices Fall

Large price movements, whether upward or downward, adversely affect the economy by hindering efficient allocation of resources and distorting income distribution. In addition to this, we have to bear in mind the following three problems that are inherent in the situation when prices fall. The first problem concerns the impact of an increase in the burden of debt. When prices fall and firms' sales and the income of households decrease, borrowers, whether firms or households, will face difficulty in repaying debt and this may cause bankruptcies. Although the price fall benefits lenders, namely financial institutions, by pushing up the real value of the principal and the interest received, it also involves a possible increase in nonperforming loans (NPLs) if borrowers cannot repay their debts. When financial institutions' risk-taking capacity deteriorates due to the accumulation of NPLs, this may adversely affect the overall economy. The second problem is the impact of an increase in the burden of labor costs. When firms' sales decrease due to the price fall, wages may not decrease to the same extent. In this case, labor costs will remain high and corporate profits will come under great downward pressure. The reason for this situation is downward rigidity in nominal wages. It is true that an employer confronts many difficulties when reducing wages. If wages are not reduced and corporate profits come under downward pressure, employment adjustments may become inevitable and spending such as business fixed investment which is necessary for growth may be restrained. And the third problem is the impact of a rise in real interest rates. When prices fall and expectations of a further fall become strong, real interest rates will rise to the same degree. Even when a central bank needs to reduce nominal interest rates to adjust the level of real interest rates in line with developments in economic activity and prices, it will be unable to do so if nominal interest rates are already at zero percent. Consequently, real interest rates will exceed the level that is appropriate considering the state of the economy and this may cause a contraction in economic activity.

In Japan, downward pressure on prices strengthened reflecting weakness in demand, due to the abrupt slowdown in overseas economies from around the end of 2000. Consequently, people had harbored strong concerns about the risk of a deflationary spiral, a situation where a vicious circle of falling prices and declining economic activity starts to work based on the mechanism I have just described. Although the term "deflation" is defined differently and thus the state of economic activity and prices the term indicates also differs depending on who defines it, there is general agreement that Japan's economy did not in fact fall into a deflationary spiral. However, the situation where short-term interest rates were practically at zero percent and the Bank could not reduce them further created a big challenge for the Bank in terms of monetary policy. The challenge was how to prevent a further slowdown in the economy and break out of the continued fall in prices.

Price Stability and the Sound Development of the National Economy

I have described the importance of "price stability" in terms of the following: the signaling function of relative prices; the effects of price changes on income distribution; and the problems encountered when prices fall. There may be a considerable time lag before the effects of monetary policy appear in economic activity and prices, and the importance of price stability means that prices should be stable not only now but also sustainably in the longer term. In other words, it is crucial that the credibility of future price stability be maintained without expectations for inflation or deflation.

The bubble era in the second half of the 1980s, which had a great effect on Japan's economy in the 1990s, was a phase of economic expansion that began in 1986 and in 1987–88 the real GDP growth rate recorded high levels of over 5 percent annually. The year-on-year rate of increase in the CPI at the time remained extremely stable at 0–1 percent, as there was strong downward pressure on consumer prices from supply-side factors such as the fall in import prices and the reduction in electricity charges. The rate of increase in the CPI then started to accelerate gradually, but it was not until 1990–91, four years after the phase of economic expansion began, that the rate of increase in the CPI reached a level of 3–4 percent. In retrospect, this was the last phase of the economic expansion which lasted through 1991. It is a widely known fact that during this bubble era prices of assets such as land surged and then plunged, resulting in a long slowdown in the economy thereafter.

This bitter experience of Japan's economy shows that though prices may be stable at a certain point in time, that stability does not always last forever. The experience during the bubble era shows that in a situation where supply-side factors such as a fall in import prices or a reduction in electricity charges are exerting downward pressure on prices, upward pressure from an economic expansion may be under-estimated and the rate of increase in prices thereafter may accelerate faster than expected. On the other hand, even when prices are stable, there may be distortion in the economy in the form of, for example, large fluctuations in asset prices, and risks to the sound development of the economy in the future may be accumulating. It is not easy to accurately judge whether prices are stable or not at the very moment. However, a central bank has the responsibility to secure price stability, and it is essential that it always monitor price movements from the following points of view: whether price stability is not only confirmed at present but also likely to be sustainable in the future; and whether movements of prices are consistent with the sound development of the economy.

How Should Price Stability Be Measured?

Use of the CPI

I have talked about why price stability is so important. Price stability can be rephrased as a situation where various economic entities such as households and firms can make rational decisions on economic activities such as consumption and investment without being confused by changes in general prices. Two difficult questions arise in defining this situation: by what means should prices be measured; and what rate of increase in prices is desirable. I will first start with indexes used as measures of prices.

The most familiar index is the CPI. In fact, it is this index that I have in mind when talking about prices in this speech today. I will digress for a moment from the main topic to touch upon the background of the CPI, which has one of the longest histories of all economic statistics. The first CPI was compiled in 1675 in England. In the 19th century, the method of compiling the CPI was changed to something close to the present method, producing a composite of the price indexes of individual goods and services with weightings assigned according to their relative value in overall household spending. In Japan, following the first nationwide household survey conducted in 1926, a type of "cost of living index" started to be compiled by some institutions. The present CPI in Japan was compiled after World War II based on this. History tells us that the idea that prices should be closely in line with household and consumer perceptions has been widely accepted around the world.

As noted earlier, the Bank's monetary policy is "aimed at, through the pursuit of price stability, contributing to the sound development of the national economy" according to the Bank of Japan Law, and thus the state of price stability should be easily understandable to the public in order to meet the objective. Assuming that "the sound development of the national economy" eventually means improvement in the economic welfare of individual citizens, the benchmark index among various types of price indexes should cover prices of goods and services purchased by consumers. Many central banks, including those that adopt inflation targeting, which I will explain later, conduct monetary policy with the weight on price indexes that are directly linked to consumption expenditure, such as the CPI.

Price Indicators besides the CPI

Among price indexes released in Japan, there are the corporate goods price index (CGPI) and the corporate service price index (CSPI). The CGPI covers prices of goods traded between firms, including materials such as iron and steel, machinery, and equipment, and has the characteristic of being relatively sensitive to economic developments; the CSPI is a composite of prices of services transacted between firms, including advertisement, transportation, and communications, and attracts attention from overseas due to its uniqueness.

The GDP deflator is a quarterly price indicator based on value added, unlike the price indexes just described. In the short term, the direction of movement of the GDP deflator sometimes differs from that of the CPI, because the GDP deflator is calculated in a similar way to GDP, which is computed by subtracting imports from the sum of domestic demand and exports. For instance, in the current situation where import prices have been rising due to the surge in crude oil prices, prices as measured by the GDP deflator are pushed downward, whereas prices as represented by the CPI are pushed upward. The year-on-year rate of decline in the GDP deflator has accelerated considerably to 1.1 percent in the July–September quarter of 2005 from 0.4 percent in the October–December quarter of 2004. This acceleration of the decline in the GDP deflator is mainly composed of an increase from 0.5 to 0.9 percentage point in the negative contribution from the rise in the import deflator. In this regard, as the domestic demand deflator and the deflator of final consumption of households, which are components of the GDP deflator, are not directly affected by fluctuations of export or import prices, their movements may be more comprehensible than the GDP deflator. The GDP deflator covers goods and services purchased by not only households but also firms and the government, and thus its weight structure differs greatly from that of goods and services purchased by consumers. As the GDP deflator covers a large number of IT-related goods whose prices have plunged, it is more likely to decrease than the CPI. I will explain later why the rate of decline in prices of IT-related goods is so abrupt.

Though we often refer to the CPI, there are various types such as the overall CPI and the CPI excluding fresh food. At present, the CPI excluding fresh food is commonly used when assessing the price situation. This is because the underlying trend of price movements becomes clear when fresh food, whose prices sometimes fluctuate erratically due to temporary factors such as weather conditions, is excluded. A type of CPI that leaves out temporary fluctuations in, for example, fresh food prices is the "core" CPI. From a long-term perspective, both "the headline inflation rate," the rate of change in the overall CPI, and "the core inflation rate," the rate of change in the core CPI, show similar movements.

Movements of asset prices, although their characteristics differ from those of prices of general goods and services, should be monitored carefully because asset prices factor in important information such as future economic developments and because movements of asset prices may have a large impact on economic activity. It is important to not only discern upward or downward movements of asset prices but also assess what kind of expectations of people are reflected in the movements.

There are then various types of price indicators. The CPI is the basis for an accurate assessment of the price situation, but it is also important to refer to other indicators with an adequate understanding of their individual characteristics. In addition to this, it is necessary to make clear the mechanism of price movements.

The Quantitative Easing Policy and the Commitment Based on the CPI

I explained earlier that in pursuing monetary policy, it is important to have a benchmark index such as the CPI that measures the change in prices of goods and services purchased by consumers. So I will now take a look at how this view applies to current monetary policy.

More than four and a half years have passed since the Bank adopted the policy of quantitative easing in March 2001. This policy, as you are aware, consists of two pillars. First, the Bank provides funds to the money market so that the outstanding balance of current accounts at the Bank substantially exceeds the amount that financial institutions are required to hold at the Bank under the reserve requirement system. And second, the Bank has made a commitment to continue such ample provision of funds until the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) registers zero percent or higher on a sustainable basis.

This type of policy is unprecedented in Japan and abroad. As I mentioned earlier, at the time the quantitative easing policy was adopted in the spring of 2001, the economy was experiencing a downturn; business was in a slump with falling prices and there was increasing concern over the stability of the financial system. Monetary policy was in a quandary with short-term interest rates practically at zero percent, making further cuts impossible. In this environment, where the stability of prices was threatened and customary monetary policy tools had virtually been exhausted, the quantitative easing policy was adopted as a measure to maximize the effect of monetary easing.

The Bank's commitment to continue the quantitative easing policy until the CPI remains stable at or above zero percent has given rise to a misunderstanding in some quarters that the Bank's target is to achieve a zero percent CPI growth rate. The Bank's thinking was that as a result of its making a commitment to continue the current monetary easing policy into the future, interest rates including longer-term rates would stabilize at a low level. To make such a policy as effective as possible, it was considered necessary to link the Bank's policy with a specific economic indicator and to make as clear as possible its commitment in terms of policy duration. As a result, the Bank has adopted "the year-on-year rate of change in the CPI of zero percent or higher" as the criterion providing the least permissible constraint on the flexibility in its monetary policy. The commitment expressed in terms of the CPI is meant as the criterion for the continuation of the unprecedented monetary easing policy with the current account balance at the Bank as the main operating target and not as any particular target level of inflation. The achievement of a change in "the CPI of zero percent or higher" is merely a transit point on the way to a better situation where the economy achieves sustainable growth with stable prices.

The Bank releases the *Outlook for Economic Activity and Prices,* or the Outlook Report as we call it, twice a year in April and October. The Outlook Report details the outlook for economic activity and prices, and on this basis the Bank's thinking about monetary policy conduct in the near future. As stated in the Outlook Report released at the end of October, the Bank expects the CPI (excluding fresh food, on a nationwide basis) to be slightly positive on a year-on-year basis by the end of 2005 and to remain positive thereafter. Some factors may exert downward pressure on the CPI, such as the slight softening in crude oil prices at present, the planned reduction in electricity charges, and the scheduled base-year revision for calculation of the CPI. At present, however, their impact remains unclear and the Bank thinks it unnecessary to change its view that the year-on-year rate of increase in the CPI will be on an upward trend. Assuming that this proves correct and given the likely economic recovery at a moderate and sustainable pace, the possibility of a departure from the present monetary policy framework is likely to increase over the course of fiscal 2006. Whatever the case, the Bank intends, for the time being, to continue the quantitative easing policy in line with the existing policy framework. On the premise of the outlook for economic activity and prices indicated in the October Outlook Report, if the conditions in the Bank's commitment to continue the policy are met and the policy framework is changed to one that sets short-term interest rates as the main operating target, it is likely that the Bank will have latitude in conducting monetary policy through the entire process.

Desirable Rate of Increase in the CPI

Bias of Price Indexes

As I have explained repeatedly, it is important to accept as a benchmark the index that covers prices of goods and services purchased by consumers. If so, what rate of increase in prices should be targeted from a medium- to long-term perspective? Before going into this question, I would like to explain in some detail two key concepts, "the measurement error in price indexes" and "a safety margin for deflation."

The CPI is a composite of the price indexes of individual goods and services with weightings assigned according to their relative value in overall household spending. In the current environment, where technological innovation is swift and change in the economic structure rapid, it is necessary that each of the subindexes and weightings accurately reflect such changes. Let us, for example, consider a case where a new product takes the place of a previous product. In compiling a price index, the price of the new product will be adopted and that of the previous one dropped. If the two products differ in quality, it is necessary to eliminate the price differential due to the difference in quality. Let me take the example of the price index for personal computers (PCs). I mentioned earlier that prices of PCs and IT-related goods are falling rapidly. This is partly due to the actual fall in prices and partly to the improvement in product quality. Let us assume that a new PC is sold at 200,000 yen, the same price as an old PC, but with double the functions. The price of the new product will then be included in the index as 100,000 yen, half the actual selling price. The practice of adjusting price indexes downward by regarding an improvement in quality as a reduction in the price is used for many other goods and services. However, it is quite difficult to measure the quality of goods and services and too costly to strictly apply adjustment to each and every good and service. Furthermore, the spending behavior of households may change responding to the emergence of a new product, making it necessary to change the pattern of weighting for the subgroup indexes. It is not easy to assess and reflect such changes in a timely manner.

For these reasons, price indexes are subject to measurement error or bias. The size of the bias is changeable as it is affected by the pace of technological innovation, changes in the economic structure, and, additionally, improvements in the method of statistical compilation. At present, the weighting is revised every five years, and at the same time, measures are taken to improve the accuracy of the indexes. In the revision in 2000, PCs were at last included in the CPI after the so-called hedonic method of quality adjustment was applied. Furthermore, the goods and services covered in the CPI are reviewed at the intermediate time of the five-year period, resulting in the inclusion of PC printers and Internet connection charges in 2003. As a result of such efforts by the Statistics Bureau to improve accuracy, the statistical bias has decreased substantially. The extent to which the bias could affect the assessment of the price situation has decreased substantially.

Safety Margin for Deflation

Next, I will look at the concept of “a safety margin for deflation.” Since deflation, once established, is liable to breed a deflationary spiral, monetary policy needs to be carried out with allowance for some price increase and with the rate of inflation targeted at slightly above zero percent. As I pointed out earlier, the bias of price indexes can no longer have a large effect on the assessment of the price situation, and so, if there is any need for a small but positive inflation rate in conducting monetary policy it will be mainly as a buffer against deflation.

An important point to note here is that the appropriate size of the margin varies according to the constraints on monetary policy at the time. Various factors such as the elasticity of nominal wages, the level of the potential growth rate, the state of the financial system, and the availability of fiscal policy will all come into play. Downward rigidity in nominal wages, with falling prices, tends to generate a deflationary spiral by squeezing corporate profits. However, Japan suffers less from such downward rigidity since bonuses and overtime payments are used to adjust nominal wages. From this viewpoint at least, the argument that there is no need for a large margin gains validity. Nevertheless, if the potential growth rate is low, a large margin will still be required, since monetary policy is less likely to have strong stimulative effects on the economy and prices and these are vulnerable to the shock that will cause prices to fall when it occurs.

Other than the constraints on monetary policy at the time as discussed earlier, there are a number of other important issues to be considered regarding the appropriate size of the margin as well as the rate of increase in prices that is aimed at by monetary policy based on the margin. One is that even when the target rate of increase in prices has been decided, there is scope for further discussion about whether the target should be pursued and met in the immediate future. The ECB defines price stability as a year-on-year increase of below 2 percent over the medium term, while the Bank of England (BOE) aims at an annual increase of 2 percent over the medium to long term. These targets are not far from the actual average rates of inflation over the past ten years, which are 1.9 percent for the euro area and 1.6 percent for the United Kingdom. In Japan, in comparison, changes in consumer prices over the past ten years were very subdued at an annual rate of minus 0.2 percent. Taking a look at a longer time span, since the 1980s the average growth rate of the CPI for Japan was 1.2 percent compared with 3.9 percent for the United States, 2.5 percent for Germany, and

4.7 percent on the basis of the retail price index for the United Kingdom. The figure for Japan still stands at a low 1.6 percent even excluding 2001 and the years after 2001, when prices fell remarkably. Given that the inflation rate in Japan has remained low over a long period in comparison with European countries and the United States, it is very likely that decision making by Japanese economic entities has been based on expectation of a low inflation rate. Under these circumstances, it is necessary to take fully into account the public's reaction to the setting of an inflation target sharply at variance with past experience, and also the possible effect on the economy, which is on its way to achieving sustained growth, of setting a price target to be met in the immediate future.

Although the bias of price indexes no longer distorts the assessment of the price situation to any significant extent, there are still issues that need further consideration concerning the desirable rate of inflation. These include the appropriate extent of inflation as a buffer against deflation, which is dependent on the constraints on monetary policy at the time, the existence of a certain degree of inertia in the direction of price movement, and the fact that Japan's economy is on the way to achieving a sustainable pace of growth.

Price Stability and Enhanced Transparency in Monetary Policy

Lastly, I would like to touch upon inflation targeting, a monetary policy framework in which a central bank targets an explicit rate of increase in prices over the medium term. There was a time when inflation targeting was taken as a rigorous framework that required achievement of a short-term target for the inflation rate. In practice, however, most countries that have adopted this framework have secured flexibility in their management of monetary policy by setting a fairly long time frame and by making clear that the target is for the medium term. For example, the BOE releases the quarterly *Inflation Report*, setting out its present assessment and projections for inflation and GDP growth for the next three years prepared by the Monetary Policy Committee. The projected inflation is not always required to meet the 2 percent target. The BOE has made clear in its monetary policy framework that even when the price increase is out of line with the target, it will aim to ensure enough time for the inflation rate to move back to the 2 percent target to prevent the economy from becoming unstable. In 2004, the BOE raised the repo rate even though the inflation rate was 1–1.5 percent, substantially below the target. At the time, the BOE stressed that the surge in housing prices could influence consumer spending and the outlook for price increases. It appears to be common knowledge among central banks around the world that monetary policy aiming to bring price stability in the short term results in large fluctuations in economic activity, undermining price stability and sound economic development in the long run.

From this viewpoint, it is more beneficial to regard inflation targeting as one of the measures to ensure the transparency of monetary policy as a whole. Central banks that have adopted inflation targeting, such as the BOE, publish projections for the economy and prices, and it is through this framework to achieve transparency that they make public the rate of inflation their monetary policy is aiming for. Central banks that have not adopted inflation targeting in the strict sense, such as the ECB and the Federal Reserve, are also making various efforts to enhance transparency of monetary policy. It is important that central banks make quite clear their line of thought regarding the conduct of their monetary policy together with their assessment of the price situation and the economic developments behind them. If their intention is clearly explained, market participants will be in a better position to anticipate the policy measures likely to come from central banks given the particular economic environment. As a result, uncertainty about future monetary policy will diminish, opening the way for a smoother performance of the pricing function in financial markets and for more reliable expectations to be formed by economic entities coping with the changing environment of the economy and prices.

It is on the basis of this belief that we at the Bank of Japan try to explain and disseminate our view as far as possible through various means including publication of the Outlook Report, the minutes of the Monetary Policy Meetings, the *Monthly Report of Recent Economic and Financial Developments*, as well as press conferences, speeches, and the web site. The Bank releases information that is among the most comprehensive of the world's central banks. Regarding the issue of setting an inflation target, the Bank believes it important to first stand on a vantage point to take in the overall monetary environment and then consider what comprehensive policy framework will be most effective in passing on the Bank's intentions. In any case, the Bank's monetary policy aims at sustainable price stability in a long time frame, and to this end we will enhance the degree of policy transparency through an appropriate assessment of the economy and prices followed by its dissemination to the public.

CLOSING REMARKS

In this speech, I have presented my thoughts regarding price stability. After more than ten years of adjustment following the bursting of the economic bubble, Japan's economy has reached a point where a new stage of development has come into view. The most pressing issue at hand is to ensure that Japan's economy progresses onto a path of sustainable growth in an environment of stable prices. This view is broadly shared by the government and the Bank. For our part, the Bank will endeavor, through its monetary policy, to support the development of the economy in order to achieve sustainable growth in an environment of stable prices.

Publications of the Monetary Policy Meeting on October 11 and 12, 2005

Minutes

Released on November 24, 2005

The Bank's View of Recent Economic and Financial Developments

Released on October 12, 2005

English translations prepared by the Bank's staff based on the Japanese originals

MINUTES OF THE MONETARY POLICY MEETING ON OCTOBER 11 AND 12, 2005

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 Tuesday, October 11, 2005, from 2:00 p.m. to 3:52 p.m., and on Wednesday, October 12, from 9:00 a.m. to 12:17 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. S. Nakahara
Mr. H. Haru
Mr. T. Fukuma
Mr. A. Mizuno
Mr. K. G. Nishimura

Government Representatives Present

Mr. I. Ueda, Senior Vice Minister of Finance, Ministry of Finance[2]
Mr. K. Sugimoto, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance[3]
Mr. J. Hamano, Director General for Economic and Fiscal Management, Cabinet Office[3]
Mr. J. Saito, Deputy Director General for Economic and Fiscal Management, Cabinet Office[2]

Reporting Staff

Mr. E. Hirano, Executive Director (Assistant Governor)
Mr. M. Shirakawa, Executive Director
Mr. A. Yamamoto, Executive Director
Mr. H. Yamaguchi, Director-General, Monetary Affairs Department
Mr. S. Uchida, Senior Economist, Monetary Affairs Department
Mr. H. Nakaso, Director-General, Financial Markets Department
Mr. H. Hayakawa, Director-General, Research and Statistics Department
Mr. K. Momma, Deputy Director-General, Research and Statistics Department
Mr. A. Horii, Director-General, International Department

Secretariat of the Monetary Policy Meeting

Mr. Y. Nakayama, Director-General, Secretariat of the Policy Board
Mr. T. Kozu, Adviser to the Governor, Secretariat of the Policy Board
Mr. K. Murakami, Director, Secretariat of the Policy Board
Mr. S. Shiratsuka, Senior Economist, Monetary Affairs Department
Mr. N. Takeda, Senior Economist, Monetary Affairs Department[4]

I. Summary of Staff Reports on Economic and Financial Developments[5]

A. Money Market Operations in the Intermeeting Period

The Bank conducted market operations in accordance with the guideline decided at the previous meeting on September 7 and 8, 2005.[6] The outstanding balance of current accounts at the Bank moved in the 31–35 trillion yen range throughout the intermeeting period, including September 30, the day of semiannual book closings. Responses of financial institutions to the Bank's funds-supplying operations were favorable, and maturities of funds-supplying operations shortened somewhat.

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1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on November 17 and 18, 2005 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. Messrs. I. Ueda and J. Saito were present on October 12.
3. Messrs. K. Sugimoto and J. Hamano were present on October 11.
4. Mr. N. Takeda was present on October 12.
5. Reports were made based on information available at the time of the meeting.
6. The guideline was as follows:

   The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.

   Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

B. Recent Developments in Financial Markets

The weighted average of the uncollateralized overnight call rate was at around zero percent. Interest rates on term instruments rose somewhat in response to an improved perception of the economy and market participants' view that the quantitative easing policy would be terminated earlier than previously expected.

Japanese stock prices rose, reflecting increased expectations of economic recovery. The Nikkei 225 Stock Average moved at around 13,500 yen for the first time since May 2001.

Long-term interest rates increased, reflecting an improved perception of the economy, and were moving at around 1.5 percent recently.

The yen depreciated against the U.S. dollar due to increased prospects of a wider interest rate differential between Japan and the United States, and was recently being traded in the range of 114–115 yen against the dollar.

C. Overseas Economic and Financial Developments

The U.S. economy continued to expand steadily, at a pace around its potential growth rate, led mainly by household spending and business fixed investment. The core inflation rate continued to be on a moderate but steady rising trend. The effects of the two hurricanes that had struck the country since late August started to appear in some indicators, such as those relating to household spending and consumer confidence.

The euro area economy was still sluggish, although exports and production were picking up partly due to depreciation of the euro.

With regard to East Asian economies, in China both domestic and external demand continued to expand strongly. The year-on-year rate of growth in China's imports had been picking up recently. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole, although negative effects of high energy prices could be seen in some countries.

In U.S. and European financial markets, long-term interest rates rose, mainly reflecting an increase in concerns about inflation. Stock prices in the United States moved within a certain range, while those in Germany and the United Kingdom rose. In financial markets in many emerging economies, while their currencies depreciated in response to appreciation of the U.S. dollar, their stock prices rose and yield differentials between their sovereign bonds and U.S. Treasuries narrowed.

D. Economic and Financial Developments in Japan

1. Economic developments

Exports continued to increase moderately against the background of the expansion of overseas economies. Exports to China, which had been somewhat lacking in momentum, showed clear signs of a pickup. Increases in exports of IT-related goods and motor vehicle parts were becoming noticeable. Exports were expected to continue rising against the background of the expansion of overseas economies.

In the corporate sector, business fixed investment had continued to increase against the background of high corporate profits and a modest improvement in business sentiment. According to the September *Tankan* (Short-Term Economic Survey of Enterprises in Japan), business fixed investment plans for fiscal 2005 of large firms both in manufacturing and nonmanufacturing were strong, and those of small firms were revised upward steadily across a wide range of industries.

Production had basically continued its moderate increasing trend. The monthly average of industrial production in the July–August period declined marginally compared to that of the April–June quarter. However, production in the July–September quarter as a whole was projected to rise, since the decline in the July–August period seemed to be mainly due to statistical fluctuations with regard to steel ships and drugs, and the forecast index for September displayed a substantial increase. As for the outlook, production was expected to continue its uptrend, as overseas economies would continue to grow and the recovery trend of domestic demand was firm.

Inventories had recently increased somewhat in some industries, particularly in the materials industries, although they remained low from a long-term perspective. Deterioration in the inventory level diffusion index in these industries in the September *Tankan* was marginal, and this suggested that inventory adjustments had been relatively small. Shipments of electronic parts and devices recovered in the July–August period, and this confirmed the completion of inventory adjustments in that sector.

As for the employment and income situation, household income had been rising moderately, reflecting improvements in employment and wages, as various indicators for labor market conditions had been improving. Regarding the outlook, household income was likely to continue increasing gradually, since the perception among firms of having excess labor had generally dissipated and corporate profits were likely to remain high.

Private consumption had been steady. Sales indicators such as sales at department stores had shown slight declines since July as a reaction, after having been relatively strong on the whole until June. However, indicators for consumer confidence continued to be favorable on the whole, and private consumption was likely to continue recovering steadily against the background of a gradual increase in household income.

Domestic corporate goods prices had increased, mainly reflecting the effects of the rise in crude oil prices. They were expected to continue increasing mainly due to high crude oil prices. Consumer prices (excluding fresh food, on a nationwide basis) had been declining slightly on a year-on-year basis. The year-on-year rate of change in consumer prices was projected to be 0.0 percent or a slight increase toward the end of the year. This was mainly because the effects of the decline in rice prices and the reduction in electricity and telephone charges were expected to ease in a situation where supply and demand conditions continued improving gradually.

2. Financial environment

The environment for corporate finance was becoming more accommodative on the whole. The lending attitude of private banks was becoming more accommodative, and that of financial institutions as perceived by firms had also been improving. Under these circumstances, lending by private banks was around the previous year's level.

With regard to financing through capital markets, the issuing environment for CP and corporate bonds continued to be favorable, and the amount outstanding of CP and corporate bonds issued had been above the previous year's level.

The year-on-year growth rate of the monetary base and that of the money stock (M_2+CDs) were at the 1.0–2.0 percent level.

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 agreed that it continued to recover led mainly by steady domestic private demand, and this was expected to continue. They also concurred with the view that the economic recovery was likely to be sustainable, as adjustments in IT-related sectors had been completed and domestic private demand had been firm.

Members agreed that overseas economies, particularly those of the United States and East Asia, continued to expand, and were expected to continue expanding at a pace around their potential growth rates. Many members said, however, that close attention should be paid to an increase in uncertainty about the world economic outlook due to the effects of the hurricanes and the prolonged period of high crude oil prices.

On the U.S. economy, many members expressed the view that, although negative effects of the hurricanes had started to appear in some indicators as seen in a deterioration in consumer confidence, deceleration in economic activity was likely to be temporary largely because reconstruction-related demand was expected. Some members commented, however, that uncertainty about the economic outlook had been increasing, as the impact of the hurricanes on facilities for oil production and refineries was not insignificant and crude oil prices were likely to remain high. Some members noted that potential inflationary risks were beginning to be noticed, partly reflecting developments in unit labor costs, which had been posting an increase year on year. They continued that attention should be paid to whether a possible rise in long-term interest rates accompanying an increase in inflation expectations could cause adjustments in housing prices and a deterioration in household spending. One member said that the possible negative effects of a rise in long-term interest rates seemed to have been increasing, as households' financial liabilities had been expanding with a rise in real estate prices.

With regard to East Asian economies, many members expressed the view that both domestic and external demand continued to expand strongly in China. A few members said, however, that future developments in the Chinese economy should be watched closely, since there were structural factors that could destabilize the economy, such as imbalances among sectors and regions. One member pointed out that in many ASEAN economies exports had continued to increase, as adjustments in IT-related sectors had been completed.

Members agreed that Japan's exports continued to increase at a moderate pace, partly reflecting a clear pickup in exports to China, which had been somewhat lacking in momentum. Members also agreed that Japan's exports were expected to continue to rise, as overseas economies continued to expand.

Members concurred that domestic private demand continued to be firm.

With regard to developments in the corporate sector, members agreed that business fixed investment continued to increase, and was expected to continue increasing against the background of high corporate profits. Many members referred to survey results in the September *Tankan*, and said that corporate profits continued to show strong performance even though firms had been absorbing the effects of the rise in crude oil prices, and in this situation, business fixed investment was likely to continue to increase. A few members noted that the *Tankan* showed that even small firms' plans for business fixed investment had been revised upward, and this confirmed that the increase in business fixed investment was spreading to a wide range of firms.

Members concurred that positive developments in the corporate sector were spreading steadily to the household sector.

As for the employment and income situation, members agreed that the number of employees and wages had been increasing, and household income had continued to rise moderately on the whole. One member expressed the view that the rise in household income was likely to continue, as the diffusion index for employment conditions in the September *Tankan* showed that the number of firms perceiving their holdings of labor as insufficient had started to exceed the number perceiving them as excessive, regardless of the size of firms. Many members said that private consumption had been steady on the whole as seen in consumer confidence, which remained at high levels, although in some sales indicators for July and August a reaction following strong sales until June was observed. They added that private consumption was likely to continue to recover steadily against the background of a gradual increase in household income. One member commented that wealth effects were also contributing to the steady developments in private consumption.

Many members said that although the monthly average of industrial production in the July–August period declined marginally compared to that of the April–June quarter, production was basically on a moderate uptrend, the weakness being largely due to statistical fluctuations with regard to steel ships and drugs. Members agreed that shipments in IT-related sectors recovered in the July–August period, and completion of inventory adjustments in IT-related sectors was confirmed.

Based on these discussions, members agreed that, as exports continued to increase, Japan's economy would continue to experience a relatively long period of growth, albeit at a moderate pace, supported by steady domestic demand. However, since the pace of recovery was only moderate, attention should be paid to risk factors such as developments in crude oil prices, which remained high, and their effects on the world economy.

On prices, members agreed that domestic corporate goods prices had increased, mainly reflecting the surge in crude oil prices, and were expected to continue increasing. They also concurred that although consumer prices (excluding fresh food, on a nationwide basis) had recently been declining slightly on a year-on-year basis, the year-on-year rate of change in consumer prices was projected to be 0.0 percent or a slight increase toward the end of the year. This was because the effects of the decline in rice prices and the reduction in electricity and telephone charges were expected to ease, as supply and demand conditions continued to improve gradually in line with economic recovery.

One member expressed the view that if the judgment of whether the economy was in deflation was to be primarily based on the assessment of prices of goods and services consumed by households, the GDP deflator, which included other demand components such as private investment, government spending, and net exports, was not necessarily an appropriate indicator. The member continued that if the price situation was to be assessed based on GDP statistics, the deflator for consumption of households should be used. Nevertheless, it should be borne in mind that, even after the introduction of the chain-linking method, the deflator still had a downward bias as it was a Paasche index and so had a tendency to overstate a decline in prices of such products as personal computers. A different member commented that it was important to take into account the effects of the upward bias of the consumer price index (CPI) when assessing the price situation. Another member said that the term "deflation" was ambiguous and should therefore be used carefully.

Some members commented that in terms of the *Prefectural Land Price Survey*, land prices seemed to be bottoming out, given that there had been a distinct narrowing in the rate of decline in commercial and residential land prices in the three metropolitan areas (Tokyo, Osaka, and Nagoya) and that the rate of change in land prices of the 23 wards of Tokyo had become positive for the first time in 15 years.

B. Financial Developments

On the financial front, members concurred that the financial environment remained extremely accommodative. Regarding the fact that the year-on-year growth rate of the money stock had recently been at around 1.5–2.0 percent, some members noted the following points. First, firms' cash flow was abundant. Second, corporate financing means had further diversified. And third, "a shift of funds from saving to investment" had been observed. These members continued that in such a situation the relation between developments in the money stock and the growth rate of nominal GDP would remain unstable for some time and a relatively low growth rate of the money stock was consistent with sustainable economic recovery.

With regard to financial market developments, members concurred with the view that an improved perception of the economy was the main factor behind the substantial rise in stock prices and the slight increase in long-term interest rates. Some members said that the rise in stock prices was attributable to the active investment stance of foreign investors, who had responded favorably to the result of the general election and the positive view of the prospects for business performance. One member commented that developments in purchases of stock futures and sales of bond futures, mainly by foreign investors, should be monitored. A few members said that attention should be paid to margin transactions, which were increasing substantially as stock prices rose.

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

On the monetary policy stance for the immediate future, members agreed that, in a situation where the CPI had been declining slightly on a year-on-year basis, it was appropriate to maintain the current framework of the quantitative easing policy in accordance with the conditions in the Bank's commitment.

A few members expressed the view that it would be appropriate to lower the target range for the outstanding balance of current accounts at the Bank at this point mainly for the following reasons. First, as concern about financial system stability was abating, financial institutions' demand for liquidity required for funds management was on a declining trend. And second, the Bank should encourage formation of interest rates based on the market mechanism as much as possible from an early stage to ensure smooth termination of the quantitative easing policy in the future.

Against this view, the majority of members said that it was appropriate to maintain the current guideline for money market operations, including the proviso. Some members expressed the view that maintaining the outstanding balance of current accounts within the target range without impairing the functioning of the market was feasible, as responses of financial institutions to the Bank's funds-supplying operations continued to be favorable and undersubscription had occurred less frequently. A few of these members said that it could not be denied that carefully lowering the target range might become necessary if liquidity demand among financial institutions declined further in the future. However, the Bank should carefully examine issues relating to lowering the target range based on the economic situation, considering how market participants would respond.

Members discussed appropriate ways of communication concerning the future conduct of monetary policy. They agreed that as a result of the Bank's communication recently, the view had become prevalent among market participants that the economic recovery was sustainable and the possibility of a departure from the quantitative easing policy was likely to increase over the course of fiscal 2006. Some members said that it was important for the Bank to explain more clearly that the effects of the quantitative easing policy were increasingly coinciding with the effects of short-term interest rates being at practically zero percent, and thus a change of the policy framework itself did not imply an abrupt change in terms of effects of policy.

As for the Bank's communication concerning its policy conduct after the termination of the quantitative easing policy, many members said that the Bank should keep an appropriate balance between ensuring smooth formation of expectations in financial markets and maintaining the flexibility of its conduct of monetary policy to respond to changes in the economic and financial situation. Members agreed that these points relating to the Bank's communication should be examined thoroughly in the process of preparing the *Outlook for Economic Activity and Prices* to be released at the end of October. A few members expressed the view that the Bank should communicate based on a consensus achieved through discussions at Monetary Policy Meetings.

IV. Remarks by Government Representatives

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

(1) Japan's economy was recovering at a moderate pace. However, deflation persisted as evidenced, for example, by the year-on-year rate of decline in the CPI and the GDP deflator. As crude oil prices remained at high levels, their effects on the domestic and overseas economies would require close monitoring.

(2) Ensuring the sustainability of the economic recovery led by private demand and overcoming deflation continued to be the most important policy tasks the government should tackle together with the Bank, and the utmost efforts to achieve these aims continued to be necessary. Therefore, the government would like the Bank to continue to examine economic activity and prices thoroughly, and explain carefully to the public and market participants that the Bank's stance of firmly maintaining the current quantitative easing policy remained unchanged in a situation where deflation persisted.

The representative from the Cabinet Office made the following remarks.

(1) Japan's economy was recovering at a moderate pace. However, deflation persisted and overcoming it continued to be the most important policy task the government should tackle.

(2) The year-on-year growth rate of the money stock (M_2+CDs) was still only at the 1.0–2.0 percent level despite the economic recovery, and various factors had been pointed out as responsible for this. Recently, however, a recovery of the credit creating function of banks was in prospect, mainly because concern about financial system stability had disappeared and the year-on-year change in lending by private banks (after adjustment for special items) had finally turned positive.

(3) It was essential that the money stock increase in the end in overcoming deflation. The government therefore hoped that the Bank would implement effective monetary policy that would be consistent with the government's policy efforts to overcome deflation and with its outlook for the economy. In assessing the state of deflation, a comprehensive analysis of price developments based not only on consumer prices but also on the GDP deflator would be necessary. The government would like the Bank to give due consideration mainly to the following factors: the effects of the rise in crude oil prices in relation to the mechanism of price formation; other special factors; and statistical bias, and carefully assess the current situation of and outlook for consumer prices. The government hoped that the Bank would contribute to overcoming deflation by promoting proper formation of expectations in financial markets.

V. Votes

Based on the above discussions, the majority of members agreed that it was appropriate to maintain the current guideline, including the proviso, for money market operations with the target for the outstanding balance of current accounts at the Bank at around 30 to 35 trillion yen.

One member, however, said that the member would like to propose that the Bank should lower the target for the outstanding balance of current accounts at the Bank from "around 30 to 35 trillion yen" to "around 27 to 32 trillion yen." A different member said that the member would like to propose that the Bank should lower the target for the outstanding balance of current accounts at the Bank from "around 30 to 35 trillion yen" to "around 25 to 30 trillion yen."

As a result, the following proposals were submitted and put to the vote.

Mr. T. Fukuma proposed the following guideline for money market operations for the intermeeting period ahead:

The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 27 to 32 trillion yen.

Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target.

The proposal was defeated by majority vote.

Votes for the proposal: Mr. T. Fukuma.
Votes against the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, Mr. A. Mizuno, and Mr. K. G. Nishimura.

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

The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 25 to 30 trillion yen.

The proposal was defeated by 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. S. Nakahara, Mr. H. Haru, Mr. T. Fukuma, and Mr. K. G. Nishimura.

To reflect the majority view, the chairman formulated the following proposal.

The Chairman's Policy Proposal on the Guideline for 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 conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.

Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, and Mr. K. G. Nishimura.
Votes against the proposal: Mr. T. Fukuma and Mr. A. Mizuno.

Mr. T. Fukuma dissented from the above proposal, arguing that the Bank should lower the target range for the outstanding balance of current accounts at the Bank gradually in a step-by-step manner, while carefully examining economic and financial developments, as long as the maintenance of the current framework of the quantitative easing policy would not be hindered. Noting the current situation where market participants had factored in a scenario where the Bank would terminate the quantitative easing policy over the course of fiscal 2006, he gave the following three reasons. First, the Bank should encourage formation of interest rates based on the market mechanism as much as possible to promote communication with market participants. Second, the Bank should shorten maturities of funds-supplying operations to enhance the timeliness and flexibility of its conduct of monetary policy. And third, it was possible to support the ongoing economic recovery and thereby emergence from the situation of slight price declines by maintaining the zero interest rate environment based on the Bank's commitment in terms of policy duration.

Mr. A. Mizuno dissented from the proposal for the following reasons. First, there had been no change from the downtrend in financial institutions' precautionary demand for liquidity, and thus lowering the outstanding balance of current accounts at the Bank as a response to this was reasonable policy conduct. Second, to ensure financial market stability in the period around the termination of the quantitative easing policy, it would be appropriate to start lowering the outstanding balance in line with developments in the market, rather than lowering it intensively over a short period of time after achieving the three conditions in the Bank's commitment to continue the policy. And third, delaying the lowering of the target range involved economic cost, for example, continuation of an abnormal situation where the massive outstanding balance of current accounts at the Bank had been restraining a rise in interest rates on term instruments and hindering interest rates from performing their function.

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 unanimous vote, the text of "The Bank's View." It was confirmed that "The Bank's View" would be published on October 12, 2005 and the whole report on October 13, 2005.[7]

VII. Approval of the Minutes of the Monetary Policy Meeting

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of September 7 and 8, 2005 for release on October 17, 2005.

Attachment

October 12, 2005
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by 7–2 majority vote, to set the following guideline for money market operations for the intermeeting period:

> The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.
>
> Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

7. The English version of the whole report was published on October 14, 2005.

THE BANK'S VIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS[8]

Japan's economy continues to recover.

Exports have continued to increase moderately, and industrial production has also been on an uptrend with some fluctuations. Business fixed investment has continued to increase against the background of high corporate profits and a modest improvement in business sentiment. Household income has also continued rising moderately, reflecting the improvement in employment and wages. In this situation, private consumption has been steady. Housing investment has recently shown some increases. Meanwhile, public investment has basically been on a downtrend.

Japan's economy is expected to continue to recover.

Exports are expected to continue rising against the background of the expansion of overseas economies. Domestic private demand is likely to continue increasing against the background of high corporate profits and the moderate rise in household income, while structural adjustment pressure stemming from the excess capacity and debt of firms has almost dissipated. In light of these increases in demand both at home and abroad, production is also expected to follow an increasing trend. Public investment, meanwhile, is projected to remain on a downtrend.

On the price front, domestic corporate goods prices have increased, mainly reflecting the effects of the rise in crude oil prices. Consumer prices (excluding fresh food) have been declining slightly on a year-on-year basis, partly due to the reduction in electricity and telephone charges.

Domestic corporate goods prices are expected to continue increasing, mainly due to high crude oil prices. Meanwhile, the year-on-year rate of change in consumer prices is projected to be 0.0 percent or a slight increase toward the end of the year. This is because the negative contribution of rice prices is likely to dissipate and the effects from the reduction in electricity and telephone charges are expected to ease, in a situation where supply and demand conditions continue improving gradually.

As for the financial environment, the environment for corporate finance is becoming more accommodative on the whole. The issuing environment for CP and corporate bonds is favorable. Also, the lending attitude of private banks is becoming more accommodative. The lending attitude of financial institutions as perceived by firms has been improving. The pace of decline in credit demand in the private sector is becoming somewhat moderate. Under these circumstances, the amount outstanding of lending by private banks is around the previous year's level, and that of CP and corporate bonds issued has been above the previous year's level. The year-on-year growth rates of the monetary base and the money stock are at the 1.0–2.0 percent level. The year-on-year growth rate of banknotes in circulation is at the 2.0–3.0 percent level. As for developments in financial markets, money market conditions continue to be extremely easy, as the Bank of Japan continues to provide ample liquidity. In the foreign exchange and capital markets, long-term interest rates and stock prices have risen compared with last month, while the yen's exchange rate against the U.S. dollar has fallen compared with last month.

8. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 11 and 12, 2005. It is based on information available at the time of the meeting.

Publications of the Monetary Policy Meeting on October 31, 2005

Minutes

Released on December 21, 2005

Outlook for Economic Activity and Prices: The Bank's View

Released on October 31, 2005

English translations prepared by the Bank's staff based on the Japanese originals

MINUTES OF THE MONETARY POLICY MEETING ON OCTOBER 31, 2005

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, October 31, 2005, from 9:00 a.m. to 12:46 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. S. Nakahara
Mr. H. Haru
Mr. T. Fukuma
Mr. A. Mizuno
Mr. K. G. Nishimura

Government Representatives Present

Mr. I. Ueda, Senior Vice Minister of Finance, Ministry of Finance
Mr. J. Hamano, Director General for Economic and Fiscal Management, Cabinet Office

Reporting Staff

Mr. E. Hirano, Executive Director (Assistant Governor)
Mr. M. Shirakawa, Executive Director
Mr. A. Yamamoto, Executive Director
Mr. H. Yamaguchi, Director-General, Monetary Affairs Department
Mr. S. Uchida, Senior Economist, Monetary Affairs Department
Mr. H. Nakaso, Director-General, Financial Markets Department
Mr. H. Hayakawa, Director-General, Research and Statistics Department
Mr. K. Momma, Deputy Director-General, Research and Statistics Department
Mr. A. Horii, Director-General, International Department

Secretariat of the Monetary Policy Meeting

Mr. Y. Nakayama, Director-General, Secretariat of the Policy Board
Mr. T. Kozu, Adviser to the Governor, Secretariat of the Policy Board
Mr. K. Murakami, Director, Secretariat of the Policy Board
Mr. T. Kato, Senior Economist, Monetary Affairs Department
Mr. K. Kamiyama, Senior Economist, Monetary Affairs Department

I. Summary of Staff Reports on Economic and Financial Developments[2]

A. Money Market Operations in the Intermeeting Period

The Bank conducted market operations in accordance with the guideline decided at the previous meeting on October 11 and 12, 2005.[3] The outstanding balance of current accounts at the Bank moved in the 32–35 trillion yen range.

B. Recent Developments in Financial Markets

Against the background of the Bank's provision of ample liquidity, the weighted average of the uncollateralized overnight call rate was at around zero percent. Interest rates on term instruments rose, particularly those maturing beyond the fiscal year-end, in response to an improved perception of the economy and market participants' view that the quantitative easing policy would be terminated earlier than previously expected.

Although expectations that Japan's economy would continue to recover remained strong, the Nikkei 225 Stock Average moved in the range of 13,000–13,500 yen, around the same level as at the time of the previous meeting, partly because U.S.

1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on December 15 and 16, 2005 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. Reports were made based on information available at the time of the meeting.
3. The guideline was as follows:
The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.
Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

stock prices moved within a certain range. Long-term interest rates remained more or less flat on the whole.

The yen depreciated to the 115–116 yen range against the U.S. dollar partly reflecting the fact that market participants continued to expect a wider interest rate differential between Japan and the United States. With regard to the yen's exchange rate against currencies of Japan's major trading partners, the nominal effective exchange rate was on a declining trend.

C. Overseas Economic and Financial Developments

The U.S. economy continued to expand. Household spending and business fixed investment continued to increase steadily and the employment situation was on a steady improving trend. Prices had recently recorded a high increase due to the rise in energy prices, and in terms of the basic trend, the inflation rate was increasing moderately. With regard to East Asian economies, in China both domestic and external demand continued to expand strongly. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole, although negative effects of high energy prices could be seen in, for example, household spending in some economies.

In U.S. and European financial markets, long-term interest rates rose slightly. Stock prices in the United States moved within a certain range, while those in Europe weakened. In financial markets in many emerging economies, their stock prices declined and yield differentials between their sovereign bonds and U.S. Treasuries widened.

D. Economic and Financial Developments in Japan

1. Economic developments

Exports as a whole increased at a faster pace, rising by 3.3 percent in the July–September quarter on a quarter-on-quarter basis, with exports to China, which had been somewhat lacking in momentum, showing clear signs of a pickup, and exports of IT-related goods increasing noticeably.

In the corporate sector, corporate profits had remained at high levels and business fixed investment had continued to increase. According to the survey conducted by the Japan Finance Corporation for Small and Medium Enterprise in September, the proportion of small firms that had carried out business fixed investment was at a high level for both manufacturers and nonmanufacturers.

Industrial production decreased by 0.3 percent in the July–September quarter on a quarter-on-quarter basis. However, production seemed to be basically continuing its moderate increasing trend, given that the decline seemed to reflect statistical fluctuations in, for example, steel ships and that the production forecast index for October and November was at a very high level. Indices of Tertiary Industry Activity rose slightly by 0.3 percent in terms of the monthly average for the July–August period compared to that for the April–June quarter.

With regard to inventories, while the completion of inventory adjustments had been confirmed in industries related to electronic parts and devices, inventories increased in some other industries, such as materials. Inventories in the industrial sector as a whole had recently increased somewhat, although they remained low.

As for the employment and income situation, various indicators for labor market conditions continued to be on an improving trend. In private consumption, many indicators, including sales in the food services industry and sales at department stores, improved somewhat in September compared to the summer when many indicators showed slightly weak developments.

Domestic corporate goods prices had continued to increase against the background of the rise in prices of international commodities such as crude oil. Consumer prices (excluding fresh food, on a nationwide basis) had been declining slightly on a year-on-year basis, with a decrease of 0.1 percent in September. The year-on-year rate of change in consumer prices was projected to be 0.0 percent or a slight increase toward the end of the year. This was mainly because the effects of the decline in rice prices and the reduction in electricity and telephone charges were expected to ease in a situation where supply and demand conditions continued improving gradually.

2. Financial environment

The environment for corporate finance was becoming more accommodative on the whole. The lending attitude of private banks was becoming more accommodative, and that of financial institutions as perceived by firms had also been improving. Under these circumstances, lending by private banks increased slightly on a year-on-year basis.

With regard to financing through capital markets, the issuing environment for CP and corporate bonds continued to be favorable, and the amount outstanding of CP and corporate bonds issued had been above the previous year's level.

The year-on-year growth rate of the monetary base increased and was in the range of 2.5–3.0 percent in October. That of the money stock (M_2+CDs) increased to around 2.0 percent in September.

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 agreed that it continued to recover led mainly by steady domestic private demand, and that these developments were in line with the Bank's assessment to date.

Members agreed that overseas economies, particularly those of the United States and East Asia, continued to expand.

On the U.S. economy, some members said that although the effects of the hurricanes had given cause for concern, it was now certain that the economy was continuing to expand led mainly by domestic private demand, as seen in the growth rate of real GDP for the July–September quarter. Some members referred to the continuing high crude oil prices and the increase in consumer prices, and pointed out that there remained strong market concerns about inflation and a possible economic slowdown against the background of high crude oil prices. A few members commented that real estate prices, which had been rising, were recently increasing at a slower pace, and therefore future developments in them and their effects on the economy required close monitoring.

With regard to the Chinese economy, a few members said that it continued to grow strongly, with the growth rate of real GDP in the July–September quarter exceeding 9 percent. One member added that in the current situation the Chinese economy should be watched carefully for a possible reacceleration of economic growth and a heightening of inflationary pressure.

Against this background in overseas economies, some members said that the improving trend of Japan's exports was becoming clearer on the whole, as evidenced by a pickup in exports to China, which had been lacking in momentum, and in exports of IT-related goods.

With regard to domestic demand, a few members commented that strong corporate profits continued to promote the expansion of business fixed investment. Some members expressed the view that private consumption continued to be steady against the background of improvements in the employment and income situation. Some indicators related to private consumption were showing improvement, such as indicators for services consumption and sales at department stores, although there had been somewhat weak indicators during the summer.

Some members said that production was judged to have been generally unchanged or basically continuing its moderate increasing trend, although it decreased by 0.3 percent in the July–September quarter on a quarter-on-quarter basis. This was mainly because the decline was due in part to statistical fluctuations, and also because, judging from a substantial increase in the production forecast index for October and November, production was likely to continue increasing even if it turned out to be somewhat weaker than forecasted. Some members pointed out that production in IT-related sectors had started to increase against the background of completion of inventory adjustments. A few members, however, commented that future developments in production in IT-related sectors required close monitoring, pointing out factors such as that the pace of recovery of production in IT-related sectors was moderate compared to past recoveries in production, prices of some products were slightly weak, and the inventory cycle of IT-related sectors might be becoming shorter than that of non-IT-related sectors.

Some members said that domestic corporate goods prices had continued to increase due mainly to the effects of the rise in prices of commodities, in particular crude oil, at home and abroad. Many members said that although consumer prices (excluding fresh food, on a nationwide basis) declined slightly by 0.1 percent on a year-on-year basis in September, there was no change to their projection that the year-on-year rate of change in consumer prices would likely turn to zero percent or a slight increase toward the end of 2005 as the effects of the decline in rice prices and the reduction in electricity and telephone charges dissipated. One member added that it should be noted that the pace of decline in unit labor costs was slowing due to the rise in labor costs and this in turn was reducing downward pressure on prices.

A few members said that it was confirmed at the meeting of general managers of the Bank's branches and in the *Regional Economic Report*, which was released on October 20, 2005, that the economy was on a recovery trend in most regions, although there were differences in the degree of improvement.

One member commented that real estate prices in Japan were at a turning point from a decline to an increase in contrast to those overseas, and therefore future developments required careful monitoring.

B. Financial Developments

On the financial front, members concurred that the financial environment remained extremely accommodative.

Some members said that in financial markets long-term interest rates had risen somewhat reflecting the slight strengthening of the outlook for economic activity and prices in Japan, while stock prices had been steady. Some members noted that the yen was depreciating against the U.S. dollar reflecting a wider interest rate differential between Japan and the United States.

C. Outlook for Economic Activity and Prices

With regard to the outlook for economic activity and prices, members agreed on the following assessment: Japan's economy was likely to experience a sustained period of expansion at a pace slightly above its potential over the course of fiscal 2006.

Members said that the underlying assumptions and mechanisms behind this economic outlook were as follows.

First, exports were likely to remain on an increase as overseas economies were likely to continue expanding at a pace around their potential growth rates. Second, corporate profits were likely to remain at high levels even with the effects of high crude oil prices factored in. Business fixed investment was also likely to continue increasing as firms had mostly completed adjustments in excess production capacity and debt. Third, strong corporate performance was expected to positively influence the household sector via increases in employment and wages, as well as increases in dividends and stock prices. Finally, the extremely accommodative financial conditions were likely to support private demand.

Members commented on the background to the outlook for Japan's economy that it was expected to experience a sustained period of recovery, albeit at a moderate pace. They agreed that, in a situation where corporate behavior would generally remain cautious, economic recovery was likely to remain moderate but at the same time excessive build-up of stocks was likely to be avoided.

On prices, members agreed that domestic corporate goods prices were likely to record a relatively large increase in fiscal 2005 and would probably continue increasing in fiscal 2006, albeit at a slower pace, with a caveat that the actual outcome would depend heavily on developments in crude oil and other commodity markets.

Many members said that the year-on-year rate of change in the consumer price index (CPI) was likely to be around zero percent in fiscal 2005 and a positive figure in fiscal 2006, in view of the gradually narrowing output gap and the weakening downward pressures from unit labor costs as an increasing number of firms perceived themselves as short of labor. One member referred to the revision of the base year for the CPI in summer 2006, and expressed the view that although the extent of the impact was not clear yet, it was likely to be smaller than that of the previous revision when the base year was changed from 1995 to 2000 and new items such as personal computers were covered.

Many members raised the following upside and downside risks to the above outlook: the path of crude oil prices; the path of the global economy, particularly that of the U.S. economy; and the path of domestic private demand. They also said that the Bank should point out both upside and downside risks to the outlook for price developments and raised the following risks unique to prices: the uncertainty over developments in the prices of crude oil and other commodities; an increase in inflationary expectations against the background of a sustained narrowing of the output gap; and the intensification of competition among firms reflecting, for example, further deregulation.

With regard to the path of crude oil prices, one member expressed the view that high crude oil prices would be compatible with the expansion of the global economy, because the primary factor behind this surge was increased global demand. A few members pointed out that, as the possibility could not be ruled out that supply-side constraints might tighten, careful attention should be paid to the risk that this could cause economic stagnation with rising prices. Some members said that, if crude oil prices remained high, the global economy might be adversely affected by an increase in consumer prices for a broad range of items or a rise in concerns over increasing inflationary pressures with a concomitant rise in interest rates.

Some members commented on the U.S. economy that attention should be paid to the risk of a downturn in the buoyant household spending as a result, for example, of downward pressure on real disposable income due to high crude oil prices and a consequent deterioration in consumer confidence, or of a change from the uptrend in housing prices. Some members noted the rise in potential inflationary risks due to the surge in crude oil prices and the increase in unit labor costs, and said that its impact on U.S. financial markets and the international flow of funds should be watched closely. One member referred to the Chinese economy and said that it would require close monitoring for possible effects of supply constraints in, for example, energy and of avian flu.

Based on the above outlook for economic activity and prices, members concurred that the Bank should clearly explain its basic thinking on the future conduct of monetary policy in the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report).

Members raised the following points. First, the effects of the quantitative easing policy were increasingly coinciding with the effects of short-term interest rates being at practically zero percent. Thus, a change of the policy framework itself would not imply an abrupt change in terms of effects of policy. Second, the possibility of a departure from the present monetary policy framework was likely to increase over the course of fiscal 2006. Third, in relation to changing the policy framework, the Bank would need to monitor financial market conditions carefully when reducing the outstanding balance of current accounts. And fourth, regarding the course of monetary policy after the change of the framework which would be conceptually outlined in the Outlook Report, it was likely that the Bank would have latitude in conducting monetary policy through the entire process during and after the change of the framework. On the fourth point, one member added that appropriately changing the policy framework with the right timing would give the Bank latitude in conducting monetary policy after the change of the framework.

Many members said that in order to ensure smooth formation of interest rates in financial markets, reflecting the conditions underlying economic activity and prices, it was essential that the Bank clearly explain its assessment of economic activity and prices as well as the thinking behind the conduct of monetary policy and endeavor to stabilize market expectations. One of these members said that since interest rates fluctuated reflecting market participants' outlook for economic activity and prices as well as their expectations about the Bank's conduct of monetary policy, to ensure smooth formation of interest rates it was extremely important that the Bank did not misjudge the appropriate timing in conducting monetary policy. Some members said that it was not possible for the Bank to completely stabilize market expectations through its communication with the public and therefore the Bank should make this point clear to avoid misunderstanding. One member expressed the view that the Bank could consider some way of providing an anchor for price stability.

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

On the monetary policy stance for the immediate future, members agreed that, in a situation where the CPI had been declining slightly on a year-on-year basis, it was appropriate to maintain the current framework of the quantitative easing policy in accordance with the conditions in the Bank's commitment.

A few members expressed the view that it would be appropriate to lower the target range for the outstanding balance of current accounts at the Bank at this point mainly for the following reasons. First, financial institutions' demand for liquidity required for funds management was on a declining trend. And second, the Bank should encourage formation of interest rates based on the market mechanism as much as possible to ensure smooth termination of the quantitative easing policy in the future.

Against this view, the majority of members said that it was appropriate to maintain the current guideline for money market operations, including the proviso. One member expressed the view that maintaining the outstanding balance of current accounts within the target range without impairing the functioning of the market was feasible, as responses of financial institutions to the Bank's funds-supplying operations continued to be favorable.

One member expressed the following view in relation to how to judge whether the conditions in the Bank's commitment had been fulfilled. In October 2003, the Bank clarified its commitment in order to provide a clearer explanation of the commitment to continue the quantitative easing policy until the year-on-year rate of change in the CPI registered zero percent or higher on a sustainable basis. The first and second conditions in the commitment were closely linked and it was meaningless to discuss them separately, and thus they should be considered together when judging whether they had been fulfilled. After making that judgment, the Bank should examine whether there was still a rationale for continuing the quantitative easing policy. It was important for the Bank to confirm through this process that the year-on-year rate of change in the CPI was registering zero percent or higher on a sustainable basis. A different member said that how the upward bias of the CPI should be taken into account was also an issue to be discussed.

IV. Remarks by Government Representatives

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

(1) The Bank would present its outlook for economic activity and prices for fiscal 2006 in the October Outlook Report to be released after the meeting. The outlook for consumer prices and the conduct of monetary policy described in the Outlook Report were a particular focus of market participants' attention in relation to the Bank's commitment to continuing the quantitative easing policy.

(2) In this regard, first, even if Policy Board members' forecasts of the real GDP growth rate and the rate of change in the CPI for fiscal 2005 and 2006 were revised upward in the October Outlook Report from those in the April Outlook Report, Japan's economy, in terms of price developments, continued to be in deflation and risk factors such as crude oil prices and the global economy continued to require close attention as mentioned in the October Outlook Report.

(3) Second, with regard to the future conduct of monetary policy, the government would like the Bank to closely monitor developments in financial markets and overall interest rates to ensure that deflation was overcome. Since there was a risk that the release of the October Outlook Report might create a situation where various speculations about the Bank's future conduct of monetary policy could easily arise, the government would like the Bank to carefully explain to market participants and the public that it would firmly continue with the current quantitative easing policy in overcoming deflation.

The representative from the Cabinet Office made the following remarks.

(1) Japan's economy was recovering at a moderate pace. However, deflation persisted and overcoming it continued to be an important policy task the government should tackle.

(2) Although it was expected that Japan's economy would experience a sustained period of expansion, due consideration should be given to the fact that the risk that developments in crude oil prices could affect corporate profits, prices, and the household sector was not negligible. In assessing the state of deflation, a comprehensive analysis of price developments based not only on consumer prices but also on the GDP deflator would be necessary. The GDP deflator was still declining on a year-on-year basis. The government would like the Bank to carefully assess the consumer price situation, giving due consideration mainly to the effects of the rise in crude oil prices, special factors, and statistical bias. The growth rate of the money stock was still low despite the economic recovery. However, a recovery of the credit creating function could be expected, mainly because concern about financial system stability had disappeared and the year-on-year change in lending by private banks (after adjustment for special items) had finally turned positive. It was essential that the money stock increase in overcoming deflation. The government therefore hoped that the Bank would implement effective monetary policy that would be consistent with the government's policy efforts to overcome deflation and with its outlook for the economy and that would eventually lead to an increase in the money stock.

(3) The government would like the Bank to consider presenting a desirable price level and the future path, including the Bank's thinking about the course in reaching that level, in order to promote proper formation of expectations in financial markets, and thereby contribute to sustainable

economic growth with price stability and the overcoming of deflation.

V. Votes

Based on the above discussions, the majority of members agreed that it was appropriate to maintain the current guideline, including the proviso, for money market operations with the target for the outstanding balance of current accounts at the Bank at around 30 to 35 trillion yen.

One member, however, said that the member would like to propose that the Bank should lower the target for the outstanding balance of current accounts at the Bank from "around 30 to 35 trillion yen" to "around 27 to 32 trillion yen." A different member said that the member would like to propose that the Bank should lower the target for the outstanding balance of current accounts at the Bank from "around 30 to 35 trillion yen" to "around 25 to 30 trillion yen."

As a result, the following proposals were submitted and put to the vote.

Mr. T. Fukuma proposed the following guideline for money market operations for the intermeeting period ahead:

> The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 27 to 32 trillion yen.
>
> Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target.

The proposal was defeated by majority vote.

Votes for the proposal: Mr. T. Fukuma.
Votes against the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, Mr. A. Mizuno, and Mr. K. G. Nishimura.

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

> The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 25 to 30 trillion yen.

The proposal was defeated by 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. S. Nakahara, Mr. H. Haru, Mr. T. Fukuma, and Mr. K. G. Nishimura.

To reflect the majority view, the chairman formulated the following proposal.

The Chairman's Policy Proposal on the Guideline for 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 conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.
>
> Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, and Mr. K. G. Nishimura.
Votes against the proposal: Mr. T. Fukuma and Mr. A. Mizuno.

Mr. T. Fukuma dissented from the above proposal, arguing that the Bank should lower the target range for the outstanding balance of current accounts at the Bank gradually in a step-by-step manner, while carefully examining economic and financial developments, as long as the maintenance of the current framework of the quantitative easing policy would not be hindered. Noting the current situation where market participants had gradually factored in a scenario where the Bank would terminate the quantitative easing policy, he gave the following three reasons. First, the Bank should encourage formation of interest rates based on the market mechanism as much as possible to restore the proper functioning of the market. Second, the Bank should shorten maturities of funds-supplying operations to enhance the timeliness and flexibility of its conduct of monetary policy. And third, it was possible to support the ongoing economic recovery and thereby emergence from the situation of slight price declines by maintaining the zero interest rate environment based on the Bank's commitment in terms of policy duration.

Mr. A. Mizuno dissented from the proposal for the following reasons. First, there had been no change from the downtrend in financial institutions' precautionary demand for liquidity, and thus lowering the outstanding balance of current accounts at the Bank as a response to this was reasonable policy conduct. Second, the quantitative easing policy should be terminated with appropriate timing, but to ensure financial market stability in the period around the termination of the quantitative easing policy it would be appropriate to start lowering the outstanding balance in line with developments in the market, rather than lowering it over a short period of time after achieving the conditions in the Bank's commitment to continue the policy. And third, delaying the lowering of the target range involved economic cost, for example, continuation of an abnormal situation where the massive outstanding balance of current accounts at the Bank had been restraining a rise in interest rates on term instruments and hindering interest rates from performing their function.

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 unanimous vote, the text of "The Bank's View." It was confirmed that "The Bank's View" would be published immediately after the meeting and the whole report on November 1, 2005.

Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, Mr. T. Fukuma, Mr. A. Mizuno, and Mr. K. G. Nishimura.
Votes against the proposal: None.

Attachment

October 31, 2005
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by 7–2 majority vote, to set the following guideline for money market operations for the intermeeting period:

The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.

Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

OUTLOOK FOR ECONOMIC ACTIVITY AND PRICES (OCTOBER 2005): THE BANK'S VIEW[4]

I. Outlook for Economic Activity and Prices

Japan's economy continues to recover, having emerged from the temporary pause that began in the second half of 2004. Compared with the projection in the April 2005 *Outlook for Economic Activity and Prices* (the April outlook), overall economic activity has been more robust, because higher-than-expected domestic private demand has more than offset slightly lower-than-expected exports. The adjustments in production and inventory in IT-related sectors, which triggered the economy's temporary pause, appear to have run their course.

From the second half of fiscal 2005 through fiscal 2006, Japan's economy is likely to experience a sustained period of expansion at a pace slightly above its potential. This economic outlook rests on the following underlying assumptions and mechanisms. First, exports are likely to remain on the increase reflecting the continuing expansion of overseas economies. Second, the corporate sector is likely to continue to show strength. Corporate profits continue to increase, on top of three consecutive years of growth, and business fixed investment is likely to continue increasing as firms have mostly completed adjustments in excess production capacity and debt. Third, strong corporate performance is positively influencing the household sector via increases in wages and employment, as well as increases in dividends and stock prices. Against this backdrop, private consumption is expected to recover steadily. Finally, the extremely accommodative financial conditions are likely to support private demand. Firms' financing conditions have eased substantially, reflecting financial institutions' more active lending stance and the increased variety of financing channels available to firms. The accommodative financial conditions seem to be contributing to the increases in business fixed investment by small- and medium-sized enterprises (SMEs) and housing investment.

However, firms are still generally cautious in building up stocks of, for example, fixed capital, in view of the protracted period of low economic growth following the bursting of the bubble. While firms are beginning to make more efficient use of cash flow—not only paying off debts but also increasing capital investments and financing strategic partnerships—they still appear cautious about accelerating inventory and capital investments in response to increases in sales and production. As a result of such corporate behavior, economic recovery is likely to remain moderate, but at the same time the recovery is likely to be sustained as excessive build-up of stocks is being avoided.

Given this economic outlook, the environment influencing prices is likely to change gradually. The output gap is likely to continue narrowing moderately under the path of economic developments described above. Capacity constraints as perceived by firms in terms of capital stock and employment are currently at the strongest level in more than a decade. The decline in unit labor costs is likely to slow along with increases in wages, despite the fact that the rise in productivity would still tend to hold them down. Meanwhile, firms and households are gradually shifting up their expectations for inflation.

Regarding specific indices for inflation, the domestic corporate goods price index has deviated above the April outlook, recording relatively large increases on a year-on-year basis, due to rising prices of crude oil and other commodities. The index is likely to record a relatively large increase in fiscal 2005 and will probably continue increasing in fiscal 2006, albeit at a slower pace, with a caveat that the actual outcome will depend heavily on developments in crude oil and other commodity markets.

The consumer price index (excluding fresh food, on a nationwide basis) has generally moved in line with the April outlook, declining slightly on a year-on-year basis, reflecting persistent effects of special factors such as the decline in rice prices and the reduction in electricity and telephone charges. As the effects of these factors fall off, the year-on-year changes in the consumer price index will likely turn to zero percent or a slight increase toward the end of 2005. Thereafter, the year-on-year changes are expected to remain positive, in view of the gradually narrowing output gap and the weakening downward pressures from unit labor costs. This means that the year-on-year rate of change in the consumer price index is likely to be around zero percent in fiscal 2005 and a positive figure in fiscal 2006.

4. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 31, 2005.

II. Positive and Negative Deviations

The outlook described above rests on the underlying assumptions and mechanisms mentioned earlier. It should be noted that there are following upside and downside risks to the outlook in the coming months.

The first is the path of crude oil prices. Crude oil prices have surged since 2004 and have recently recorded historical highs. One of the primary factors of this surge is increased global demand, reflecting developments such as high growth in emerging economies, and to that extent, high crude oil prices may be compatible with the expansion of the global economy. However, if crude oil prices rise further, due to, for example, supply-side constraints, the global economy may be adversely affected by a decline in real purchasing power in non-oil-producing countries, or rising concerns over increasing inflationary pressures worldwide with a concomitant rise in interest rates.

The second factor is the path of the global economy, including U.S. economic developments. In the United States, inflationary expectations have generally been contained, with the Federal Reserve continuing to raise the federal funds rate target at a measured pace. Financial conditions in the United States have remained accommodative, as evidenced by relatively low and stable long-term interest rates and historically tight credit spreads. The favorable financial conditions have supported buoyant spending by households, as house prices climbed higher. This, in turn, has supported economic expansion. Should this cycle be disrupted, due to, for example, unexpected changes in monetary accommodation in light of rising inflationary expectations, not only growth in the United States would slow, but the global economy could also be adversely affected, perhaps via a shift in the international flow of funds.

In the case of a major external shock, for example, an unexpected slowdown of overseas economies, economic growth in Japan may slow, notwithstanding the recent strength in domestic private demand.

The third factor is the path of domestic private demand. The outlook rests on the assumption that corporate behavior will generally remain cautious. However, firms are increasingly enjoying an improvement in the investment climate, with a high level of return on assets comparable to that recorded during the bubble economy period, and with high capital ratios resulting from repayment of debt and the extremely low cost of corporate debt. Meanwhile, the stimulative effects of low interest rates are being amplified as the economy continues to recover. If firms become more confident about the economic outlook, they may embark on more active investment programs. If there are also stronger positive influences from the corporate sector to households via increases in employee income and dividend payments, household spending may increase. These developments would entail an acceleration of economic recovery.

As for price developments, there are both upside and downside risks to the outlook. The risks to real economic activity, mentioned above, would correspondingly impact prices, if they ever materialize. In addition, there are risks unique to prices. First is the uncertainty over developments in the prices of crude oil and other commodities. Depending on the direction of their fluctuations, general price levels may deviate either upward or downward. Second, although it appears that the impact of economic activity on prices has recently been weakening, a sustained narrowing of the output gap may cause a greater-than-anticipated increase in inflationary expectations. This can prompt firms to pass increases in costs, including past increases, onto sales prices, thus causing prices to deviate upward. Finally, the intensification of competition among firms, reflecting, for example, further deregulation, may cause downward deviation in prices.

III. Conduct of Monetary Policy

The Bank has been providing extremely ample liquidity under the quantitative easing policy. The two pillars of the quantitative easing policy are: the Bank's provision of ample liquidity to the money market so that the outstanding balance of current accounts at the Bank substantially exceeds the amount of required reserves; and the Bank's commitment to continue with this ample provision of liquidity until the year-on-year rate of change in the consumer price index (excluding fresh food, on a nationwide basis) registers zero percent or higher on a sustainable basis.

When there were strong concerns over the stability of the financial system, the ample provision of liquidity by the Bank, which met financial institutions' liquidity demand, stabilized financial markets and maintained accommodative financial conditions, and contributed to averting a contraction in economic activity. In financial markets, the Bank's ample provision of liquidity pushed short-term interest rates to practically zero percent. Longer-term interest rates have stably remained at low levels because the commitment by the Bank has led the market to expect that short-term interest rates will remain at zero percent when prices continue to decline slightly. Recently, however, concerns about financial system stability have subsided substantially. At the same time, with more market participants expecting that prices will stop declining and start rising, there is a shortening of the duration of the quantitative easing policy as expected by market participants. As a result, the policy commitment is gradually losing its influence on the formation of longer-term interest rates. Thus the stimulative effects of the quantitative easing policy on economic activity and prices are increasingly coinciding with the effects of short-term interest rates being at practically zero percent.

In the money market, where the Bank conducts its market operations, precautionary demand for liquidity has declined substantially, reflecting diminishing concerns over financial system stability. When demand for liquidity is extremely weak, measures adopted by the Bank in its market operations may, in some instances, hinder the natural formation of the yield curve and the efficient functioning of markets, even if the measures may enable the Bank to maintain a target balance of current accounts. Taking this into consideration, since May 2005, the Bank has allowed the outstanding balance of current accounts to fall temporarily short of the target range when demand for funds is judged to be extremely weak. Recently, with the improvement in the economic outlook, financial institutions are more actively bidding in the Bank's longer-maturity funds-supplying operations. Consequently, the maturity of funds-supplying operations, which has lengthened substantially since the beginning of 2005, may now be shortened without jeopardizing the Bank's ability to maintain the outstanding balance of current accounts within the target range. These developments are, to some extent, contributing to the reinvigoration of natural mechanisms for price formation in financial markets, which reflect underlying conditions of the economy and prices.

Assuming that developments would follow the projection described in this Outlook Report, the possibility of a departure from the present monetary policy framework is likely to increase over the course of fiscal 2006. Such a change would mean a reduction in the outstanding balance of current accounts toward a level in line with required reserves, and a shift in the main operating target for money market operations from the outstanding balance of current accounts to short-term interest rates. In reducing the outstanding balance of current accounts, the Bank will need to monitor financial market conditions carefully, because the quantitative easing policy has been in place for a long period of time. However, with strengthening expectations that prices will start rising, the effects of the quantitative easing policy are increasingly coinciding with the effects of short-term interest rates being at practically zero percent. Thus a change of the policy framework itself does not imply an abrupt change in terms of effects of policy. Conceptually, the course of monetary policy after the change of the framework will be a period of very low short-term interest rates followed by a gradual adjustment to a level consistent with economic activity and price developments.

The change of the policy framework as well as the level and time-path of short-term interest rates thereafter will depend on future developments in economic activity and prices as well as financial conditions. If it is judged that upward pressure on prices continues to be contained and the economy follows a sustainable and balanced growth path, this is likely to give the Bank latitude in conducting monetary policy through the entire process.

Given that the change of the current policy framework, as with the introduction of the quantitative easing policy, is unprecedented, it is essential to ensure that financial markets are able to perform pricing function smoothly, reflecting underlying conditions of the economy and prices. In order to realize sustainable economic growth and stable prices, the Bank will clearly explain its assessment of economic activity and prices as well as the thinking behind the conduct of monetary policy, and will endeavor to stabilize market expectations, while taking measures in an appropriate and timely manner in response to economic and financial developments.

Forecasts of the Majority of Policy Board Members[1,2]

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2005	**+2.2 to +2.5 [+2.2]**	**+1.6 to +1.8 [+1.7]**	**0.0 to +0.1 [+0.1]**
Forecasts made in April 2005	**+1.2 to +1.6 [+1.3]**	**+0.8 to +1.0 [+0.8]**	**−0.1 to +0.1 [−0.1]**
Fiscal 2006	**+1.6 to +2.2 [+1.8]**	**+0.5 to +0.8 [+0.6]**	**+0.4 to +0.6 [+0.5]**
Forecasts made in April 2005	**+1.3 to +1.7 [+1.6]**	**+0.2 to +0.5 [+0.3]**	**+0.2 to +0.4 [+0.3]**

Notes: *1.* Brackets indicate the median of the forecasts.
2. The forecasts of Policy Board members are based on the assumption that there will be no change in monetary policy.

Forecasts of the majority of Policy Board members are the figures to which the individual members attach the highest probability and they are shown as a range, with the highest and lowest figures excluded. It should be noted that the range does not indicate the forecast errors.

The forecasts of all Policy Board members are as follows.

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2005	**+2.0 to +2.7**	**+1.6 to +2.0**	**0.0 to +0.1**
Forecasts made in April 2005	**+1.1 to +1.8**	**+0.7 to +1.0**	**−0.1 to +0.1**
Fiscal 2006	**+1.3 to +2.4**	**+0.4 to +1.0**	**+0.4 to +0.6**
Forecasts made in April 2005	**+1.2 to +2.2**	**+0.1 to +0.5**	**+0.1 to +0.5**

Publications of the Monetary Policy Meeting on November 17 and 18, 2005

Minutes

Released on December 21, 2005

The Bank's View of Recent Economic and Financial Developments

Released on November 18, 2005

English translations prepared by the Bank's staff based on the Japanese originals

MINUTES OF THE MONETARY POLICY MEETING ON NOVEMBER 17 AND 18, 2005

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 Thursday, November 17, 2005, from 2:00 p.m. to 3:40 p.m., and on Friday, November 18, from 9:00 a.m. to 12:41 p.m.[1]

Policy Board Members Present

Mr. T. Fukui, Chairman, Governor of the Bank of Japan
Mr. T. Muto, Deputy Governor of the Bank of Japan
Mr. K. Iwata, Deputy Governor of the Bank of Japan
Ms. M. Suda
Mr. S. Nakahara
Mr. H. Haru
Mr. T. Fukuma
Mr. A. Mizuno
Mr. K. G. Nishimura

Government Representatives Present

Mr. K. Akaba, Senior Vice Minister of Finance, Ministry of Finance[2]
Mr. K. Sugimoto, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance[3]
Mr. Y. Nakajo, Vice Minister for Policy Coordination, Cabinet Office

Reporting Staff

Mr. M. Shirakawa, Executive Director
Mr. A. Yamamoto, Executive Director
Mr. H. Yamaguchi, Director-General, Monetary Affairs Department
Mr. S. Uchida, Senior Economist, Monetary Affairs Department
Mr. H. Nakaso, Director-General, Financial Markets Department
Mr. H. Hayakawa, Director-General, Research and Statistics Department
Mr. K. Momma, Deputy Director-General, Research and Statistics Department
Mr. A. Horii, Director-General, International Department

Secretariat of the Monetary Policy Meeting

Mr. Y. Nakayama, Director-General, Secretariat of the Policy Board
Mr. T. Kozu, Adviser to the Governor, Secretariat of the Policy Board
Mr. K. Murakami, 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 market operations in accordance with the guideline decided at the previous meeting on October 31, 2005.[5] The outstanding balance of current accounts at the Bank moved in the 31–35 trillion yen range. Responses of financial institutions to the Bank's funds-supplying operations had been generally favorable, but undersubscription had been observed recently.

B. Recent Developments in Financial Markets

The weighted average of the uncollateralized overnight call rate was at around zero percent. As for interest rates on term instruments, both three-month Euro-yen rates and yields on three-month treasury bills (TBs) and financing bills (FBs) were stable at low levels.

1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on December 15 and 16, 2005 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. Akaba was present on November 18.
3. Mr. K. Sugimoto was present on November 17.
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 conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.

   Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

Japanese stock prices rose, reflecting a rebound in U.S. stock prices and announcements of strong business performance by many Japanese firms. The Nikkei 225 Stock Average returned to the 14,000–15,000 yen level for the first time since May 2001.

Long-term interest rates increased to around 1.6 percent, reflecting rises in U.S. long-term interest rates and Japanese stock prices, but weakened thereafter, moving at around 1.5 percent. This was mainly due to a slight decline in U.S. long-term interest rates and buybacks of Japanese government bonds (JGBs), mainly by foreign investors, in response to comments made by government officials.

The yen depreciated against the U.S. dollar due to increased prospects of a wider interest rate differential between Japan and the United States, and was being traded at around 119 yen to the dollar for the first time since August 2003. It depreciated against the currencies of most of Japan's major trading partners, and its nominal effective exchange rate declined substantially.

C. Overseas Economic and Financial Developments

The U.S. economy continued to expand steadily. Household spending and business fixed investment continued to increase. Prices had recorded a high increase temporarily due to the rise in energy prices, and in terms of the basic trend, the inflation rate was increasing moderately.

The euro area economy remained somewhat sluggish, although exports and production had picked up supported by depreciation of the euro.

With regard to East Asian economies, in China both domestic and external demand continued to expand strongly. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole, although negative effects of high energy prices could be seen in, for example, household spending in some economies.

In U.S. and European financial markets, long-term interest rates had been on the rise, reflecting the persisting concern over inflation, but were declining somewhat recently due partly to a slight decrease in crude oil prices. Stock prices were rising. In financial markets in many emerging economies, their stock prices rose and yield differentials between their sovereign bonds and U.S. Treasuries narrowed.

D. Economic and Financial Developments in Japan

1. Economic developments

The first preliminary estimate of real GDP showed positive quarter-on-quarter growth for the fourth consecutive quarter in July–September. The figure was relatively strong, taking into account the high growth in the first half of 2005.

Exports continued to increase moderately against the background of the expansion of overseas economies. Exports to China, which had been somewhat lacking in momentum, and exports of IT-related goods showed clear signs of a pickup. Exports were expected to continue rising against the background of the expansion of overseas economies.

In the corporate sector, business fixed investment had continued to increase against the background of high corporate profits. However, the GDP-based figure for business fixed investment for the July–September quarter seemed to be too high and thus might be revised downward in the second preliminary estimate.

Production had been on an uptrend with some fluctuations. Industrial production declined marginally in the July–September quarter on a quarter-on-quarter basis as in the April–June quarter, but this was mainly due to statistical fluctuations in steel ships and drugs. Production was expected to continue its uptrend, as overseas economies would continue to grow and the recovery in domestic demand was solid.

Although inventories remained low from a long-term perspective, they had recently increased somewhat in some industries, particularly in materials industries. However, among materials, high-value-added products for IT-related goods and automobiles remained in a favorable supply-demand condition. Adjustment pressure on inventories, therefore, was not considered to be particularly strong.

As for the employment and income situation, household income had been rising moderately, reflecting improvements in employment and wages, as various indicators for labor market conditions had been improving. It was likely to continue increasing gradually, since the perception among firms of having excess labor had generally dissipated and corporate profits were likely to remain high.

Private consumption had been steady. Although, as a reaction to high growth in the first half of 2005, consumption of goods was lackluster, services consumption continued to be steady. On a GDP basis, private consumption continued to increase in the July–September quarter following the increase in the previous quarter. Indicators for consumer confidence continued to be favorable on the whole. Private consumption was likely to continue recovering steadily against the background of a gradual increase in household income.

Domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen. They were expected to continue increasing for the time being. Consumer prices (excluding fresh food, on a nationwide basis) had been declining slightly on a year-on-year basis. The year-on-year rate of change in consumer prices was projected to be 0.0 percent or a slight increase toward the end of the year. This was mainly because the effects of the decline in rice prices and the reduction in electricity and telephone charges were expected to ease in a situation where supply and demand conditions continued improving gradually.

2. Financial environment

The environment for corporate finance was becoming more accommodative on the whole. The lending attitude of private banks was becoming more accommodative, and that of financial institutions as perceived by firms had also been improving. Under these circumstances, lending by private banks had become higher than the previous year's level.

The issuing environment for CP and corporate bonds was favorable, and the amount outstanding of CP and corporate bonds issued had been above the previous year's level.

The year-on-year growth rate of the monetary base was around 3.0 percent, and that of the money stock (M_2+CDs) had been around 2.0 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 agreed that it continued to recover steadily with an increase in both domestic and external demand, although the pace of recovery had not accelerated since its emergence from the temporary pause.

Members agreed that overseas economies, particularly those of the United States and East Asia, continued to expand, and were likely to keep expanding at a pace around their potential growth rates.

On the U.S. economy, members concurred that household spending and business fixed investment continued to increase steadily, and in this situation production was on a moderate increasing trend and the employment situation had been improving. Many members said that judging from the latest available economic indicators, the effects of the hurricanes on the economy had not been as significant as initially thought. Some members, however, expressed the view that consumer confidence had deteriorated, mainly due to the effects of the hurricanes and of persistently high prices of petroleum products, and private consumption might slow temporarily. In response to this, a few other members commented that retail sales, except auto sales, had remained steady, and the risk of deceleration in private consumption was not significant. These members agreed that, in either case, attention should be paid to developments in Christmas sales. A few members said that some anecdotal information suggested a slowdown in the pace of increase in housing prices in urban areas, and that housing prices overall were starting to make a soft landing. Regarding U.S. stock prices, a few members pointed out that they were recovering, reflecting the market's positive reaction to the fact that the rise in crude oil prices had come to a halt. Some members said that since future developments in prices remained highly uncertain, attention should continue to be paid to the possibility of a change in the accommodative U.S. financial conditions triggered by a rise in concern about inflation.

With regard to East Asian economies, members agreed that both domestic and external demand continued to expand strongly in China, and the NIEs and ASEAN economies continued to recover led by the increase in exports. One member said that the expansion in production capacity in China over the course of fiscal 2006 might have a negative impact on supply and demand conditions in global materials markets. Some members expressed the view that anxiety over the spread of avian flu was growing in some East Asian economies, and if human infection with avian flu became widespread, their economies might be seriously affected.

Regarding Japan's economy, members agreed that exports continued to increase moderately and were likely to continue to rise, as overseas economies continued to expand.

Members concurred that domestic private demand continued to be firm.

With regard to developments in the corporate sector, members agreed that business fixed investment had continued to increase and was likely to keep increasing, since domestic and external demand was expected to continue increasing and corporate profits were likely to remain high. A few members said that according to the revised figure for business fixed investment plans for fiscal 2005 in the Survey of Capital Investment by Small Sized Manufacturers conducted by the Japan Finance Corporation for Small and Medium Enterprise, their business fixed investment for fiscal 2005 would increase for the third consecutive year, and this confirmed that the increase in business fixed investment was spreading to a wide range of firms. As for the outlook, many members expressed the view that, while firms had been absorbing the effects of the rise in crude oil prices, their interim results suggested that corporate profits remained strong, and therefore momentum in business fixed investment was very likely to be sustainable. One member said that firms might become more inclined to make business fixed investment in production facilities in Japan rather than overseas against the background of the continuing depreciation of the yen.

Members concurred that positive developments in the corporate sector were spreading steadily to the household sector.

As for the employment and income situation, members agreed that the number of employees and wages had been increasing, and household income had continued to rise moderately on the whole. Many members expressed the view that the household sector would enjoy the effects of positive developments in the corporate sector not only through winter bonus payments, which were expected to be higher than last year's, but also through other channels besides earned income, such as a rise in stock prices and an increase in dividends. Members agreed that private consumption had been basically steady, given that services consumption had been generally steady and consumer confidence remained at high levels, although consumption of goods was lackluster in the July–September quarter as a reaction to high growth in the first half of 2005. Some members pointed out that sales of automobiles had recently been relatively sluggish, but this was partly attributable to the fact that no major new models had been introduced. Members concurred that private consumption was likely to continue to recover steadily against the background of a gradual increase in household income. A few members said that if consumers were shifting up their expectations for inflation to some extent, as suggested by the Consumer Confidence Survey, private consumption might increase more than expected as a result of an easing of consumers' stance of postponing purchases of durable goods in anticipation of a fall in prices. A few members said that housing investment had recently shown some strength partly because the decline in land prices was coming to a halt.

Members agreed that production had basically continued on a moderate increasing trend, and would continue its uptrend. Some members commented that, although it was expected that production would increase in the October–December quarter, there were uncertainties, such as future developments in adjustments in inventories of materials and U.S. Christmas sales, and therefore close monitoring would be needed.

Based on these discussions, members agreed that, as exports continued to increase and domestic demand was steady, Japan's economy was likely to experience a relatively long period of growth, albeit at a moderate pace. They also concurred that attention should continue to be paid to risk factors such as developments in crude oil prices and their effects on economic activity and prices, since the pace of recovery was only moderate.

On prices, members agreed that domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen, and were expected to continue increasing. They also concurred that although consumer prices (excluding fresh food, on a nationwide basis) had currently been declining slightly on a year-on-year basis, the year-on-year rate of change in consumer prices was projected to be 0.0 percent or a slight increase toward the end of the year. This was mainly because the effects of the decline in rice prices and the reduction in electricity and telephone charges were expected to ease in a situation where supply and demand conditions continued improving gradually in line with economic recovery. Referring to the fact that crude oil prices were declining somewhat and some electric power companies had announced a reduction in electricity charges from April 2006, members discussed the outlook for prices presented in the *Outlook for Economic Activity and Prices* (hereafter the Outlook Report) released in October 2005. With regard to the recent decline in crude oil prices, one member commented that the Bank should carefully examine whether it reflected changes in their trend. Many members said that it was unnecessary for the Bank to change its assessment that the year-on-year rate of change in the consumer price index (CPI) was likely to rise above zero percent and remain positive, given that, since the release of the October Outlook Report, the yen had been depreciating, the output gap had improved, and the pace of decline in unit labor costs had been slowing. A few members said that if the potential growth rate had become higher than the Bank's assumed rate of approximately 1 percent presented in the Outlook Report, this might affect the Bank's outlook for prices through developments in the output gap and unit labor costs. Members agreed that it was important to take into account characteristics of each price indicator in order to appropriately assess price developments.

B. Financial Developments

On the financial front, members concurred that the financial environment remained extremely accommodative. With regard to the year-on-year change in lending by private banks (after adjustment for special items), which had recently been positive, members concurred that this reflected the fact that their lending attitude was becoming more accommodative and the pace of decline in credit demand in the private sector had been moderate. A few members said that the behavior of financial institutions, including how private banks' lending developed, should be watched carefully. One of these members commented that not only developments in lending but also a change in the overall flow of money should be monitored, as households were diversifying their financial assets from safe assets, particularly deposits, to riskier ones.

With regard to financial market developments since the release of the October Outlook Report, members agreed that they had been generally calm. Noting the rise in stock prices and the depreciation of the yen against the currencies of Japan's major trading partners, many members expressed the view that market participants generally agreed that Japan's economic activity was steady and were becoming more aware of wider interest rate differentials between Japan and overseas economies. One member commented that the yen might start to appreciate if, for example, it became the prevalent view that rises in U.S. interest rates would come to a halt in the near future. Another member expressed the view that the rise in stock prices had caused changes, through a lower earnings-price ratio, in the yield spread (government bond yield minus earnings-price ratio), which had been significantly below zero percent, and this might suggest a decline in investors' perception of risks involved in holding stocks. Some members said that the rise in stock prices and the depreciation of the yen might have been partly promoted by the decline in real interest rates, which reflected the improved outlook for prices, and the financial environment might be becoming more accommodative recently.

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

On the monetary policy stance for the immediate future, members agreed that it was appropriate to maintain the current framework of the quantitative easing policy in accordance with the Bank's commitment.

A few members expressed the view that it would be appropriate to lower the target range for the outstanding balance of current accounts at the Bank at this point mainly for the following reasons. First, financial institutions' demand for liquidity required for funds management was on a declining trend. And second, the Bank should encourage formation of interest rates based on the market mechanism as much as possible to ensure smooth termination of the quantitative easing policy in the future. Against this view, the majority of members said that it was appropriate to maintain the current guideline for money market operations, including the proviso. One member expressed the view that, although undersubscription had begun to be observed again in funds-supplying operations, the Bank could for the time being maintain the outstanding balance of current accounts within the target range without impairing the functioning of the market by taking various measures to improve money market operations.

Members discussed matters relating to communication concerning the future conduct of monetary policy. They agreed that, due to the appropriate explanation in the October Outlook Report, there was fairly wide acceptance, at least among market participants, of the Bank's view, which was as follows. First, it was becoming more likely that the economic recovery would be sustainable. Second, the year-on-year rate of change in consumer prices (excluding fresh food, on a nationwide basis) was projected to be 0.0 percent or a slight increase toward the end of the year, and it was expected to basically remain positive thereafter. And third, under these circumstances, the possibility of a departure from the present monetary policy framework was likely to increase over the course of fiscal 2006.

Some members, however, said that the Bank's thinking concerning a change of the policy framework and the conduct of monetary policy after the change might not have been fully understood by the public, especially non-market participants. These members said that, in order to enhance the understanding of a wider range of people concerning the meaning of a change of the policy framework and other matters explained in the October Outlook Report, the Bank should continue to explain clearly the following points among others. First, a change of the policy framework itself did not imply an abrupt change in terms of the effects of policy, and the accommodative financial environment was likely to be maintained even after the change of the policy framework if upward pressure on prices was contained and Japan's economy followed a sustainable and balanced growth path. And second, there would be in any case no change in the Bank's stance of striving to achieve sustainable growth with price stability.

A few members expressed the view that it was worth considering indicating a desirable rate of inflation that the Bank should pursue in the conduct of monetary policy, from the viewpoint of providing an anchor for economic agents' expectations regarding future developments in economic activity and prices and communicating the Bank's policy intention more clearly. Against this view, some members made the following points among others. First, a desirable rate of inflation was an objective for the medium to long term, and this must be fully understood by the public. Second, it was difficult to indicate a desirable rate of inflation for the medium to long term in the current situation where Japan's economy was still in the process of moving toward sustainable growth with price stability. And third, economic agents might have been making decisions based on the assumption that the rate of inflation would continue to be relatively low, since it had been continuously low in Japan. Members agreed that it was important for the Bank to keep an appropriate balance between enhancing the transparency of its conduct of monetary policy and securing flexibility and timeliness in its future policy conduct when communicating its thinking concerning it to the public.

IV. Remarks by Government Representatives

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

(1) Japan's economy was recovering at a moderate pace, as seen, for example, in the recently released first preliminary estimates of GDP statistics for the July–September quarter, which showed increases in private consumption and business fixed investment. In terms of the price situation, however, deflation persisted.

(2) Ensuring the sustainability of the economic recovery led by private demand and overcoming deflation were the most important policy tasks the government should tackle together with the Bank. To ensure the achievement of these policy tasks, the government would like the Bank to carry out in its conduct of monetary policy a careful and comprehensive assessment of economic activity and prices, including risk factors such as crude oil prices and the global economy, with close monitoring of developments in financial markets and overall interest rates.

(3) The government considered that, in the current economic situation where deflation persisted, steady and sustained policy efforts were necessary to overcome it. Therefore, the government would like the Bank to carefully explain to market participants and the public that it would firmly continue with the current quantitative easing policy.

The representative from the Cabinet Office made the following remarks.

(1) Japan's economy was recovering at a moderate pace. However, deflation persisted, as seen in the GDP deflator, which had declined for the 30th consecutive quarter, and overcoming deflation continued to be an important policy task the government should tackle together with the Bank.

(2) In assessing the state of deflation, a comprehensive analysis of price developments based not only on consumer prices but also on the GDP deflator would be necessary. As for the assessment of the current situation of and outlook for consumer prices, which were the basis for the

necessary conditions for terminating the quantitative easing policy, the government would like the Bank to give due consideration mainly to the following factors: the effects of the rise in crude oil prices in relation to the mechanism of price formation; other special factors; and statistical bias.

(3) The government hoped that the Bank would implement effective monetary policy to overcome deflation in fiscal 2006 that would be consistent with the government's outlook for the economy. Furthermore, the government would like the Bank to consider presenting a desirable price level and the future path, including the Bank's thinking about the course in reaching that level, in order to promote proper formation of expectations in financial markets, and thereby contribute to sustainable economic growth with price stability and the overcoming of deflation.

V. Votes

Based on the above discussions, the majority of members agreed that it was appropriate to maintain the current guideline, including the proviso, for money market operations with the target for the outstanding balance of current accounts at the Bank at around 30 to 35 trillion yen.

Two members, however, said that they would like to propose that the Bank should lower the target for the outstanding balance of current accounts at the Bank from "around 30 to 35 trillion yen" to "around 27 to 32 trillion yen."

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

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

> The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 27 to 32 trillion yen.
>
> Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

The proposal was defeated by majority vote.

> Votes for the proposal: Mr. T. Fukuma and Mr. A. Mizuno.
>
> Votes against the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, and Mr. K. G. Nishimura.

To reflect the majority view, the chairman formulated the following proposal.

The Chairman's Policy Proposal on the Guideline for 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 conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.
>
> Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

> Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, and Mr. K. G. Nishimura.
>
> Votes against the proposal: Mr. T. Fukuma and Mr. A. Mizuno.

Mr. T. Fukuma dissented from the above proposal. He said that, although he agreed with the Bank's basic thinking presented in the October Outlook Report concerning a change of the policy framework and the conduct of monetary policy after the change, the Bank should lower the target range for the outstanding balance of current accounts at the Bank gradually in a step-by-step manner, while carefully examining economic and financial developments, as long as the maintenance of the current framework of the quantitative easing policy would not be hindered, for the following three reasons. First, the

Bank should encourage formation of interest rates based on the market mechanism as much as possible to restore the proper functioning of the market. Second, the Bank should shorten maturities of funds-supplying operations to enhance the timeliness and flexibility of its conduct of monetary policy. And third, it was possible to support the ongoing economic recovery and thereby emergence from the situation of slight price declines by maintaining the zero interest rate environment based on the Bank's commitment in terms of policy duration.

Mr. A. Mizuno dissented from the proposal for the following reasons. First, to ensure financial market stability in the period around the termination of the quantitative easing policy, it would be appropriate to start lowering the outstanding balance in line with developments in the market, rather than lowering it intensively over a short period of time. Second, to minimize the possible shocks from the termination of the policy, the Bank should create an environment where it could communicate with market participants via interest rates. And third, delaying the lowering of the target range might increase the criticism that the Bank was responsible for accelerating the depreciation of the yen and causing global asset inflation.

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 unanimous vote, the text of "The Bank's View." It was confirmed that "The Bank's View" would be published on November 18, 2005 and the whole report on November 21, 2005.[6]

VII. Approval of the Minutes of the Monetary Policy Meeting

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of October 11 and 12, 2005 for release on November 24, 2005.

Attachment

November 18, 2005
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by 7–2 majority vote, to set the following guideline for money market operations for the intermeeting period:

> The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.
>
> Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

6. The English version of the whole report was published on November 22, 2005.

THE BANK'S VIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS[7]

Japan's economy continues to recover.

Exports have continued to increase moderately, and industrial production has also been on an uptrend with some fluctuations. Business fixed investment has continued to increase against the background of high corporate profits. Household income has also continued rising moderately, reflecting the improvement in employment and wages. In this situation, private consumption has been steady. Housing investment has shown some strength. Meanwhile, public investment has basically been on a downtrend.

Japan's economy is expected to continue to recover.

Exports are expected to continue rising against the background of the expansion of overseas economies. Domestic private demand is likely to continue increasing against the background of high corporate profits and the moderate rise in household income, while structural adjustment pressure stemming from the excess capacity and debt of firms has almost dissipated. In light of these increases in demand both at home and abroad, production is also expected to follow an increasing trend. Public investment, meanwhile, is projected to remain on a downtrend.

On the price front, domestic corporate goods prices have continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen. Consumer prices (excluding fresh food) have been declining slightly on a year-on-year basis, partly due to the reduction in electricity and telephone charges.

Domestic corporate goods prices are expected to continue increasing for the time being, mainly due to the effects of the rise in international commodity prices and the depreciation of the yen. Meanwhile, the year-on-year rate of change in consumer prices is projected to be 0.0 percent or a slight increase toward the end of the year. This is because the negative contribution of rice prices is likely to dissipate and the effects from the reduction in electricity and telephone charges are expected to ease, in a situation where supply and demand conditions continue improving gradually.

As for the financial environment, the environment for corporate finance is becoming more accommodative on the whole. The issuing environment for CP and corporate bonds is favorable. Also, the lending attitude of private banks is becoming more accommodative. The lending attitude of financial institutions as perceived by firms has been improving. The pace of decline in credit demand in the private sector is very moderate. Under these circumstances, the amount outstanding of lending by private banks has become above the previous year's level, and that of CP and corporate bonds issued has been above the previous year's level. The year-on-year growth rate of the monetary base is around 3.0 percent, and that of the money stock has been around 2.0 percent. The year-on-year growth rate of banknotes in circulation was around 3.0 percent in October, but it has been decreasing since the beginning of November due to the introduction of the new series of banknotes in the same month last year. As for developments in financial markets, money market conditions continue to be extremely easy, as the Bank of Japan continues to provide ample liquidity. In the foreign exchange and capital markets, stock prices have risen compared with last month, while the yen's exchange rate against the U.S. dollar has fallen compared with last month. Meanwhile, long-term interest rates have been around the same level as last month.

7. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on November 17 and 18, 2005. It is based on information available at the time of the meeting.

Publications of the Monetary Policy Meeting on December 15 and 16, 2005

Minutes

Released on January 25, 2006

The Bank's View of Recent Economic and Financial Developments

Released on December 16, 2005

English translations prepared by the Bank's staff based on the Japanese originals

MINUTES OF THE MONETARY POLICY MEETING ON DECEMBER 15 AND 16, 2005

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 Thursday, December 15, 2005, from 2:01 p.m. to 4:00 p.m., and on Friday, December 16, from 9:00 a.m. to 12:27 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. S. Nakahara
Mr. H. Haru
Mr. T. Fukuma
Mr. A. Mizuno
Mr. K. G. Nishimura

Government Representatives Present

Mr. K. Akaba, Senior Vice Minister of Finance, Ministry of Finance[2]
Mr. K. Sugimoto, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance[3]
Mr. Y. Nakajo, Vice Minister for Policy Coordination, Cabinet Office

Reporting Staff

Mr. E. Hirano, Executive Director (Assistant Governor)
Mr. M. Shirakawa, Executive Director
Mr. A. Yamamoto, Executive Director
Mr. H. Yamaguchi, Director-General, Monetary Affairs Department
Mr. M. Ayuse, Deputy Director-General, Monetary Affairs Department[4]
Mr. S. Uchida, Senior Economist, Monetary Affairs Department
Mr. H. Nakaso, Director-General, Financial Markets Department
Mr. H. Hayakawa, Director-General, Research and Statistics Department
Mr. K. Momma, Deputy Director-General, Research and Statistics Department[5]
Mr. A. Horii, Director-General, International Department

Secretariat of the Monetary Policy Meeting

Mr. Y. Nakayama, Director-General, Secretariat of the Policy Board
Mr. T. Kozu, Adviser to the Governor, Secretariat of the Policy Board
Mr. K. Murakami, Director, Secretariat of the Policy Board
Mr. Y. Yamada, Director, Monetary Affairs Department[4]
Mr. K. Masaki, Senior Economist, Monetary Affairs Department
Mr. N. Takeda, Senior Economist, Monetary Affairs Department
Mr. K. Etoh, Deputy Director-General, Financial Markets Department[4]

I. Summary of Staff Reports on Economic and Financial Developments[6]

A. Money Market Operations in the Intermeeting Period

The Bank conducted market operations in accordance with the guideline decided at the previous meeting on November 17 and 18, 2005.[7] The outstanding balance of current accounts at the Bank moved in the 30–35 trillion yen range.

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1. The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on January 19 and 20, 2006 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. Akaba was present on December 16.
3. Mr. K. Sugimoto was present on December 15.
4. Messrs. M. Ayuse, Y. Yamada, and K. Etoh were present on December 16 from 9:00 a.m. to 9:19 a.m.
5. Mr. K. Momma was present on December 16.
6. Reports were made based on information available at the time of the meeting.
7. The guideline was as follows:

> The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.
>
> Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank’s funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

B. Recent Developments in Financial Markets

The weighted average of the uncollateralized overnight call rate was at around zero percent. As for interest rates on term instruments, both Euro-yen rates and yields on treasury bills (TBs) and financing bills (FBs) were stable at low levels.

Japanese stock prices rose, reflecting announcements of business performance by Japanese firms and the rise in U.S. stock prices. The Nikkei 225 Stock Average was recently moving in the range of 15,000–15,500 yen.

Long-term interest rates decreased against the background of a fall in U.S. interest rates, but increased thereafter reflecting stronger-than-expected Japanese economic indicators and the rise in stock prices. They were recently moving in the range of 1.50–1.55 percent.

The yen depreciated to the 120–121 yen range against the U.S. dollar reflecting stronger-than-expected U.S. economic indicators and prospects of a wider interest rate differential between Japan and the United States, but appreciated thereafter partly because the yen was bought back by some foreign investors. It was recently being traded in the range of 116–120 yen to the dollar. From a longer-term perspective, the yen was on a depreciating trend against a wide range of currencies such as the dollar, euro, and those of Asian economies.

C. Overseas Economic and Financial Developments

The U.S. economy continued to expand. Household spending and business fixed investment continued to increase steadily and the employment situation had been improving. Although prices had recorded a high increase temporarily due to the rise in energy prices, the inflation rate was increasing moderately in terms of the basic trend.

In the euro area, although the economy remained somewhat sluggish, the momentum for recovery was gradually increasing as evidenced by the pickup in exports and production partly due to depreciation of the euro.

With regard to East Asian economies, in China both domestic and external demand continued to expand strongly. The NIEs and ASEAN economies continued to expand at a moderate pace on the whole, although negative effects of high energy prices could be seen in, for example, household spending in some economies.

In U.S. and European financial markets, long-term interest rates showed relatively large fluctuations reflecting market participants' outlook for the conduct of monetary policy and their response to economic indicators. Stock prices rose, partly reflecting the halt in the rise in crude oil prices and strong corporate profits. In financial markets in many emerging economies, their currencies and stock prices rose.

D. Economic and Financial Developments in Japan

1. Economic developments

Exports continued to increase against the background of the expansion of overseas economies. Exports to the United States and East Asia continued to increase, and the rise in those to the European Union was gradually becoming noticeable. Exports were expected to continue rising against the background of the further expansion of overseas economies.

In the corporate sector, business fixed investment had continued to increase against the background of high corporate profits. According to the December *Tankan* (Short-Term Economic Survey of Enterprises in Japan), current profits remained at high levels regardless of the type of industry and size of firm. Business sentiment had continued to improve moderately regardless of the type of industry and size of firm, although firms were still tending to be somewhat cautious relative to their profits. Business fixed investment plans had been revised upward at a wide range of firms, and business fixed investment was expected to increase for firms as a whole for the third consecutive year. The perception among firms of having excess labor and capital stock had dissipated.

Production had been on an uptrend with some fluctuations. Industrial production increased, mainly in electronic parts and devices and general machinery, in terms of the figure for October compared with the monthly average for the July–September quarter. Production was expected to continue its uptrend, as overseas economies would continue to grow and the recovery in domestic demand was solid.

Inventories had been relatively high in materials industries. However, high-value-added products for IT-related goods and automobile-related goods remained in a favorable supply-demand condition, and thus the effects of inventory adjustments in materials industries seemed to be limited.

As for the employment and income situation, household income had been rising moderately, reflecting improvements in employment and wages. Somewhat positive developments in the labor force participation rate had been observed, as the employment situation had continued to improve. Household income was likely to continue increasing gradually, since the perception among firms of having excess labor had dissipated and corporate profits were likely to remain high.

Private consumption had been steady. While the number of new passenger-car registrations had been weak since July, sales of electrical appliances had continued a steady increase. As for services consumption, sales in the food service industry had continued to be steady. Indicators for consumer confidence were at high levels on the whole. Private consumption was likely to continue recovering steadily against the background of a gradual increase in household income.

Domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen. They were expected to continue increasing for the time being. On the basis of corporate goods prices including imported goods, by stages of demand, the year-on-year rate of change in final goods prices had turned positive, and it was expected to affect consumer prices in the course of time. The year-on-year rate of change in consumer prices (excluding fresh food, on a nationwide basis), which had been slightly negative until then, was 0.0 percent in October. It was projected to turn slightly positive as supply-demand conditions continued improving gradually and the effects from the reduction in telephone charges dissipated.

2. Financial environment

The environment for corporate finance was becoming more accommodative on the whole. The lending attitude of private banks was becoming more accommodative, and that of financial institutions as perceived by firms had also been improving. Under these circumstances, lending by private banks had become higher than the previous year's level.

The issuing environment for CP and corporate bonds was favorable, and the amount outstanding of CP and corporate bonds issued had been above the previous year's level.

The year-on-year growth rate of the monetary base was at the 1.0–2.0 percent level, and that of the money stock (M_2+CDs) had been around 2.0 percent.

II. The Expiry of Temporary Measures, Including the Purchases of Asset-Backed Securities

A. Staff Proposal

The staff proposed that the Bank announce that it would let temporary measures relating to the purchases of asset-backed securities and the relaxing of eligibility standards for accepting asset-backed CP in its market operations expire at the end of March 2006, as scheduled, and that it would also take a necessary transitional measure.

B. Discussion by the Policy Board and Vote

Members voted unanimously to approve the proposal. A few members said that they would like the staff to continue to support relevant parties in their efforts to foster the development of credit markets.

III. Summary of Discussions by the Policy Board on Economic and Financial Developments

A. Economic Developments

On the current state of Japan's economy, members agreed that it continued to recover steadily, with domestic and external demand well balanced and the recovery spreading to a wide range of sectors.

Members agreed that overseas economies, particularly those of the United States and East Asia, continued to expand, and were likely to keep expanding.

On the U.S. economy, members concurred that it was expanding solidly. Household spending and business fixed investment continued to increase steadily, and in this situation employment, as well as production, had returned to an improving trend. A few members expressed the view that Christmas sales seemed to have started off with higher growth than in 2004. Some members said that developments in housing prices and their effects on the economy continued to warrant attention, even though there seemed to be no signs at present that there would be a rapid adjustment of housing prices. One member pointed out that the pace of increase in housing prices was slowing and the number of houses purchased was almost flat, and commented that housing demand could become sluggish as the effects of the rise in interest rates permeated in the future.

With regard to East Asian economies, members agreed that both domestic and external demand continued to expand strongly in China, and the NIEs and ASEAN economies continued to expand at a moderate pace. One member noted that production capacity was being expanded in China, and thus whether this could cause excess supply in the future warranted attention.

Some members commented on risk factors for the global economy that developments in the high crude oil prices continued to warrant attention. One member said that monetary authorities were raising interest rates in view of a global heightening of inflationary pressure, and the effects on the global economy should be monitored carefully.

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

Members concurred that domestic private demand continued to be firm as structural adjustment pressures, such as excess debt, had almost dissipated.

With regard to developments in the corporate sector, members agreed that business fixed investment had continued to increase and was likely to keep increasing, as domestic and external demand continued to increase and corporate profits remained high. Many members said that business fixed investment seemed likely to continue to increase, given that in the December *Tankan* business fixed investment plans for fiscal 2005 had been revised upward at a wide range of firms, including nonmanufacturing and small firms, and the perception among firms of having excess production capacity had dissipated.

Members concurred that positive developments in the corporate sector were spreading steadily to the household sector.

As for the employment and income situation, members agreed that the number of employees and wages had been increasing, and household income had continued to rise moderately. Some members pointed out that, in addition to the year-on-year increase in regular payments, growth in winter bonus payments seemed to have exceeded that in summer bonus payments according to survey results and other sources. A few members referred to the possibility of wage increases being agreed on in negotiations in spring 2006, particularly at firms with strong business performance. If they were realized, prices could be affected through further weakening of downward pressure on unit labor costs. One member said that firms were increasingly perceiving themselves as short of labor as evidenced by, for example, the diffusion index for employment conditions and the number of new graduates firms planned to recruit in the December *Tankan*, and it was becoming clearer that there was a new movement from reducing the number of employees to investing in human resources.

Members agreed that private consumption had been steady, and it was likely to continue to expand steadily against the background of the improvement in the employment and income situation. One member commented that, although the number of new passenger-car registrations had been weak since July 2005, sales of electrical appliances were favorable and services consumption was on an increasing trend. Some members pointed out that sales of expensive automobiles were relatively good and sales of luxury goods, such as jewelry, were favorable, and commented that these developments might be partly due to wealth effects from the rise in stock prices. A few other members expressed the view that, although attention should be paid to the impact of tax reforms to be implemented in the future, consumption was likely to remain steady for the time being, as positive developments in the corporate sector were spreading steadily to the household sector through, for example, the rise in wages.

Some members said that housing investment was likely to remain firm. One member commented that attention should be paid to the risk that recent favorable developments in housing investment might be affected if the impact of the scandal of falsification of earthquake-resistance data for building construction spread in Japan.

Members agreed that production had basically continued on a moderate increasing trend, and would continue its uptrend. A few members commented that inventory adjustments, which had continued until recently, had generally been completed as indicated by the balance between shipments and inventories in the industrial sector as a whole.

On prices, members agreed that domestic corporate goods prices had continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen, and were expected to continue increasing. They also concurred that as the year-on-year rate of change in consumer prices (excluding fresh food, on a nationwide basis), which had been slightly negative until then, was 0.0 percent in October, it would turn slightly positive mainly because the effects of the reduction in telephone charges were expected to dissipate in a situation where supply and demand conditions continued improving gradually in line with economic recovery.

Regarding price developments in the medium to long term, a few members commented that prices would remain on a rising trend despite short-term fluctuations given that the output gap was improving, wages were increasing, and people's expectations for prices were improving. One member said that the output gap might not narrow as much as expected if the economy's potential growth rate was increasing recently. In response to this, a different member argued that an increase in productivity would not necessarily exert downward pressure on prices because it could boost demand through improvement in households' and firms' expectations for income in the long term.

B. Financial Developments

On the financial front, members concurred that the financial environment remained extremely accommodative. Some members expressed the view that the financial environment was effectively becoming accommodative to an even greater extent as evidenced by a decline in real interest rates, the rise in stock prices, and the depreciation of the yen, in a situation where the environment influencing economic activity and prices had been improving.

Many members expressed the view that recent developments in stock and foreign exchange markets reflected domestic investors' increased risk-taking capacity and inclination to take risks as well as market participants' speculation regarding interest rate differentials between Japan and overseas economies in a situation where the economy was recovering. One of these members pointed out that, if market participants expected too strongly that extremely low interest rates would be prolonged, the possibility of destabilization of price formation in foreign exchange markets and other financial markets could not be ruled out. A different member pointed out that investors' perception of risks in the stock market was becoming optimistic to some extent. A few members expressed the view that the recent rise in stock prices basically reflected the upward revision of corporate profits and did not indicate that an asset price bubble was emerging. A different member who supported this view added, however, that even with stable general prices, if the extremely accommodative financial environment continued to be maintained while the momentum of the economy strengthened, this could trigger a surge in asset prices. This member said that attention should therefore be paid to the risk that, if this situation materialized, investments lacking in balance between risk and return would increase, triggering overheating of the economy and a reaction thereafter.

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

On the monetary policy stance for the immediate future, members agreed that it was appropriate to maintain the current framework of the quantitative easing policy in accordance with the Bank's commitment.

A few members expressed the view that it would be appropriate to lower the target range for the outstanding balance of current accounts at the Bank at this point mainly for the following reasons. First, financial institutions' demand for liquidity required for funds management was on a declining trend. And second, the Bank should encourage formation of interest rates based on the market mechanism as much as possible to ensure smooth termination of the quantitative easing policy in the future. Against this view, the majority of members said that it was appropriate to maintain the current guideline for money market operations, including the proviso.

Members discussed matters relating to communication concerning the conduct of monetary policy. A few members commented that although there had been various speculations and views regarding the timing of a change of the monetary policy framework and the conduct of monetary policy after the change, the Bank's basic thinking was as explained in the October *Outlook for Economic Activity and Prices*, and the Bank should clearly explain this thinking, as well as conduct monetary policy appropriately based on a careful analysis of economic activity and prices. In relation to this, one member commented that the Bank should continue to explain clearly that termination of the quantitative easing policy would not imply an abrupt change in the economy so that this was fully understood not only by market participants but also the corporate sector and the public. Some members expressed the view that the future path of the policy interest rate would depend on developments in economic activity and prices, but market participants might nevertheless be increasingly expecting that the extremely accommodative monetary policy would be prolonged regardless of the situation.

Members discussed how various price indicators should be considered in relation to the conduct of monetary policy. Some members said that it was appropriate for the Bank to conduct monetary policy taking into account price indexes that covered goods and services purchased by consumers. This was because indicators used to measure the degree of price stability should be easily understandable by the public and also the sound development of the national economy implied improvement in the economic welfare of individual citizens eventually. With regard to whether the Bank should use the headline consumer price index (CPI) or the core CPI, which excluded temporary factors, in assessing consumer price developments, one member noted that exclusion of factors causing temporary fluctuations made it easier to grasp the underlying trend, but at the same time, it made it difficult to assess overall developments if the weight of the core CPI was too small relative to the headline CPI. Many members said that although whether to exclude energy prices could be an issue from the viewpoint of eliminating temporary fluctuations, it was not appropriate to exclude them because the recent rise in energy prices had been largely caused by an increase in the demand of emerging economies and thus was not necessarily a temporary factor. One member said that in cases where the Bank examined the GDP deflator, it should take into account that it might be revised frequently and substantially with revisions of GDP statistics.

One member expressed the view that the Bank should consider indicating a desirable rate of inflation, from the viewpoint of providing an anchor for economic agents' expectations regarding future developments in economic activity and prices and contributing to stable formation of expectations in financial markets. Against this view, one member said that inflation targeting was aimed at achieving the announced inflation target in the medium to long term, and adoption of inflation targeting without the public fully understanding it could impair the flexibility of monetary policy. This member also said that if the target was set at a high level it could cause a rise in long-term interest rates via an increase in the expected inflation rate or risk premiums. A different member said that the type of inflation targeting varied significantly among countries that had introduced it, and thus it was necessary to take into account the situation in Japan when considering a framework for enhancing the Bank's monetary policy transparency. A few members expressed the view that, since the economy was still in the process of moving toward sustainable growth with price stability and the mechanism behind economic developments and price formation was changing, it was difficult at this point to determine and announce a desirable rate of inflation for the medium to long term.

V. Remarks by Government Representatives

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

(1) Japan's economy continued to recover at a moderate pace led by private demand, as seen, for example, in the recently released second preliminary estimates of GDP statistics for the July–September quarter, which showed increases in private consumption and business fixed investment. In terms of the price situation, however, deflation persisted.

(2) Ensuring the sustainability of the economic recovery and overcoming deflation were the most important policy tasks the government should tackle together with the Bank. To ensure the achievement of these policy tasks, the government would like the Bank to carry out in its conduct of monetary policy a careful and comprehensive assessment of economic activity and prices, including risk factors such as crude oil prices, with close monitoring of developments in financial markets and overall interest rates.

(3) The government considered that, in the current situation where deflation persisted, it was necessary to continue firmly with policy efforts to overcome it. Therefore, the government would like the Bank to carefully explain to market participants and the public that it would firmly continue with the current quantitative easing policy.

The representative from the Cabinet Office made the following remarks.

(1) Japan's economy was recovering at a moderate pace. However, deflation persisted and overcoming

it continued to be an important policy task the government should tackle together with the Bank.

(2) The government would release its "Economic Outlook for FY 2006 and Basic Economic and Fiscal Management Measures" on December 19, 2005. The government expected that in fiscal 2006 the economy would continue its moderate recovery led mainly by private demand and the likelihood of overcoming deflation would increase through policy efforts together with the Bank.

(3) In assessing the state of deflation, a comprehensive analysis of price developments based not only on consumer prices but also on the GDP deflator would be necessary. The government would like the Bank to give due consideration mainly to the effects of the rise in crude oil prices in relation to the mechanism of price formation, other special factors, and statistical bias, and carefully assess the current situation of and outlook for consumer prices, which were the basis for the necessary conditions for terminating the quantitative easing policy.

(4) The government hoped that the Bank would implement effective monetary policy to overcome deflation in fiscal 2006 that would be consistent with the government's outlook for the economy. Furthermore, the government would like the Bank to consider presenting a desirable price level and the future path, including the Bank's thinking about the course in reaching that level, in order to promote proper formation of expectations in financial markets, and thereby contribute to sustainable economic growth with price stability and the overcoming of deflation.

VI. Votes

Based on the above discussions, the majority of members agreed that it was appropriate to maintain the current guideline, including the proviso, for money market operations with the target for the outstanding balance of current accounts at the Bank at around 30 to 35 trillion yen.

Two members, however, said that they would like to propose that the Bank should lower the target for the outstanding balance of current accounts at the Bank from "around 30 to 35 trillion yen" to "around 27 to 32 trillion yen."

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

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

> The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 27 to 32 trillion yen.
>
> Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

The proposal was defeated by majority vote.

Votes for the proposal: Mr. T. Fukuma and Mr. A. Mizuno.
Votes against the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, and Mr. K. G. Nishimura.

To reflect the majority view, the chairman formulated the following proposal.

The Chairman's Policy Proposal on the Guideline for 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 1).

> The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.
>
> Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Ms. M. Suda, Mr. S. Nakahara, Mr. H. Haru, and Mr. K. G. Nishimura.

Votes against the proposal: Mr. T. Fukuma and Mr. A. Mizuno.

Mr. T. Fukuma dissented from the above proposal, arguing that the Bank should lower the target range for the outstanding balance of current accounts at the Bank gradually in a step-by-step manner, while carefully examining economic and financial developments, as long as the maintenance of the current framework of the quantitative easing policy would not be hindered, for the following three reasons. First, the Bank should encourage formation of interest rates based on the market mechanism as much as possible to restore the proper functioning of the market. Second, the Bank should shorten maturities of funds-supplying operations to enhance the timeliness and flexibility of its conduct of monetary policy. And third, it was possible to support sustainable economic recovery with price stability by maintaining the zero interest rate environment based on the Bank's commitment in terms of policy duration.

Mr. A. Mizuno dissented from the proposal for the following reasons. First, to ensure financial market stability in the period around the termination of the quantitative easing policy, it would be appropriate to start lowering the outstanding balance in line with developments in the market, rather than lowering it intensively over a short period of time. Second, to minimize the possible shocks from the termination of the policy, the Bank should create an environment where it could communicate with market participants via interest rates. Third, delaying the lowering of the target range for the outstanding balance of current accounts might increase the criticism that this was one factor that could cause acceleration in the depreciation of the yen and global asset inflation. And fourth, lowering the target range could be expected to send a signal to financial markets that the Policy Board would change the policy framework appropriately based on its own decision.

VII. 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 unanimous vote, the text of "The Bank's View." It was confirmed that "The Bank's View" would be published on December 16, 2005 and the whole report on December 19, 2005.[8]

VIII. Approval of the Minutes of the Monetary Policy Meetings

The Policy Board approved unanimously the minutes of the Monetary Policy Meetings of October 31, 2005 and November 17 and 18 for release on December 21, 2005.

IX. Approval of the Scheduled Dates of the Monetary Policy Meetings in January–June 2006

At the end of the meeting, the Policy Board approved the dates of the Monetary Policy Meetings to be held in the period January–June 2006, for immediate release (see Attachment 2).

8. The English version of the whole report was published on December 20, 2005.

Attachment 1

December 16, 2005
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by 7–2 majority vote, to set the following guideline for money market operations for the intermeeting period:

The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen.

Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target.

Attachment 2

December 16, 2005
Bank of Japan

Scheduled Dates of Monetary Policy Meetings in January–June 2006

	Date of MPM	Publication of Monthly Report (The Bank's View)	Publication of MPM Minutes
Jan. 2006	19 (Thur.), 20 (Fri.)	20 (Fri.)	Mar. 14 (Tue.)
Feb.	8 (Wed.), 9 (Thur.)	9 (Thur.)	Mar. 14 (Tue.)
Mar.	8 (Wed.), 9 (Thur.)	9 (Thur.)	Apr. 14 (Fri.)
Apr.	10 (Mon.), 11 (Tue.)	11 (Tue.)	May 24 (Wed.)
	28 (Fri.)	—	June 20 (Tue.)
May	18 (Thur.), 19 (Fri.)	19 (Fri.)	June 20 (Tue.)
June	14 (Wed.), 15 (Thur.)	15 (Thur.)	To be announced

Note: "The Bank's View" in the *Monthly Report of Recent Economic and Financial Developments* (Monthly Report) is scheduled to be published at 3:00 p.m. (this schedule is subject to change on certain grounds such as late closing of the meeting).

Full text of the Monthly Report will be published at 2:00 p.m. on the next business day of the publication of "The Bank's View" (English translation will be published at 4:30 p.m. on the second business day of the publication of "The Bank's View").

"The Bank's View" in the *Outlook for Economic Activity and Prices* (April 2006) will be published at 3:00 p.m. on Friday, April 28, 2006 (the whole report including the background will be published at 2:00 p.m. on Monday, May 1).

THE BANK'S VIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS[9]

Japan's economy continues to recover.

Exports have continued to increase, and industrial production has also been on an uptrend with some fluctuations. Business fixed investment has continued to increase, as corporate profits have been high and business sentiment has continued to improve. Household income has also continued rising moderately, reflecting the improvement in employment and wages. In this situation, private consumption has been steady. Housing investment has continued to show some strength. Meanwhile, public investment has basically been on a downtrend.

Japan's economy is expected to continue to recover.

Exports are expected to continue rising against the background of the expansion of overseas economies. Domestic private demand is likely to continue increasing against the background of high corporate profits and the moderate rise in household income, while structural adjustment pressure, such as the excess debt of firms, has almost dissipated. In light of these increases in demand both at home and abroad, production is also expected to follow an increasing trend. Public investment, meanwhile, is projected to remain on a downtrend.

On the price front, domestic corporate goods prices have continued to increase, mainly reflecting the rise in international commodity prices and the depreciation of the yen. The year-on-year rate of change in consumer prices (excluding fresh food), which had been slightly negative thus far, was 0.0 percent in October.

Domestic corporate goods prices are expected to continue increasing for the time being, mainly due to the effects of the rise in international commodity prices and the depreciation of the yen. The year-on-year rate of change in consumer prices is projected to turn slightly positive, as supply-demand conditions continue improving gradually and the effects from the reduction in telephone charges dissipate.

As for the financial environment, the environment for corporate finance is becoming more accommodative on the whole. The issuing environment for CP and corporate bonds is favorable. Also, the lending attitude of private banks is becoming more accommodative. The lending attitude of financial institutions as perceived by firms has been improving. The pace of decline in credit demand in the private sector is very moderate. Under these circumstances, the amount outstanding of lending by private banks has become above the previous year's level, and that of CP and corporate bonds issued has been above the previous year's level. The year-on-year growth rate of the monetary base is at the 1.0–2.0 percent level, and that of the money stock has been around 2.0 percent. The year-on-year growth rate of banknotes in circulation has decreased in reaction to the increased growth rate in November last year due to the introduction of the new series of banknotes. As for developments in financial markets, money market conditions continue to be extremely easy, as the Bank of Japan continues to provide ample liquidity. In the foreign exchange and capital markets, the yen's exchange rate against the U.S. dollar, long-term interest rates and stock prices have risen compared with last month.

9. The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on December 15 and 16, 2005. It is based on information available at the time of the meeting.

The Expansion of Corporate Groups in the Financial Services Industry: Trends in Financial Conglomeration in Major Industrial Countries (Summary)

The full text in English can be accessed at the Bank's web site (http://www.boj.or.jp/en/index.htm).

Summary

In recent years, a growing number of financial services companies in major industrial countries have begun to make inroads into each other's sectors, spurred by changing financial needs, innovations in financial engineering, deregulation, and a variety of other trends and developments. These companies include banks, securities companies, insurers, and even consumer finance and asset management/advisory firms. Among the most significant developments is the expansion of financial conglomerates, groups of financial institutions and firms that offer a wide range of services. Financial conglomerates have become notable in recent years for their growing size and the increasingly global nature of their operations.

Financial conglomeration raises new issues in terms of the stability and efficiency of financial systems. Many of the new issues raised by financial conglomeration stem from the fundamental nature of financial conglomerates themselves, which is the fact that they handle a wide range of financial services within a single corporate grouping.

As traditional regulation has divided financial services providers more or less along strict sectoral lines, financial conglomeration, which allows single groups to offer an increasingly diverse range of services, has brought significant changes, especially to their risk management practices, and thus has prompted financial authorities and safety net administrators to respond to these changes.

Financial conglomerates do not provide a single model for financial services providers seeking to expand their range of business. They vary greatly in terms of the scope and structure of their business, depending on factors such as the management strategies of their core financial services providers and the financial systems of the countries in which they operate. In addition, all of these factors change over time.

However, financial authorities and relevant parties need to be aware that conglomeration will likely remain a strong option for financial services providers. When financial services providers choose to expand their business by conglomeration, the financial authorities and relevant parties need to pursue dual objectives of maintaining the soundness of the financial system and allowing financial services providers to operate smoothly.

There is no set of universal guidelines for dealing with financial conglomeration in place around the world. Nonetheless, on the regulatory side, financial conglomeration has been the subject of active discussions in international settings, and a common awareness is being formed regarding the need to monitor what is occurring in the financial conglomerate as a whole and the importance of making active use of market discipline.

A movement toward financial conglomeration has also been taking place in Japan. Financial conglomeration has emerged and expanded since the 1990s, when banks and securities companies were allowed to enter each other's sectors. The years since 2000 have seen a series of mergers and integrations among the major banks that has led to the formation of "mega-bank" groups.

Further financial conglomeration will likely occur in Japan under current economic conditions. Japanese banks are now laying the groundwork for more forward-looking business development with their progress in the cleanup of nonperforming loans and reduction of their excessive equity holdings. They are also becoming aware that strengthening their profitability is an increasingly important task. Deregulation is moving forward as well. As this trend will likely grow, financial authorities need to closely monitor not only domestic financial conglomerates but also foreign financial conglomerates that operate in Japan.

The Bank of Japan, as a central bank, will respond to financial conglomeration to effectively carry out the Bank's operations, including current account deposits and other transactions with financial institutions, bank examinations and monitoring, as well as the "lender of last resort" function. Of special importance from the perspective of avoiding systemic risks will be accurately grasping conditions in individual groups, focusing particularly on the flow of funds and integrated risk management.

Public Relations Activities of the Bank of Japan and Its Approaches to Financial Literacy Education (Summary)

The full text in English can be accessed at the Bank's web site (http://www.boj.or.jp/en/index.htm).

Summary

The Bank of Japan considers it important to disseminate information and provide explanations to the general public, in a plain and understandable manner, about its operations and organization, as well as financial and economic developments, in addition to public relations activities through the media. In recent years, the Bank has devoted effort to financial literacy education for the next generation, which will play an important role in Japan's economy in the future.

Major examples of the Bank's recent public relations activities aimed directly at the general public include conducting in-house tours at its Head Office and branches, providing information through its web site, delivering speeches and holding seminars, as well as releasing research papers and public relations magazines. Through such activities, the Bank seeks to become a more comprehensible and open central bank for the public. Recently, the Bank has sought to make further improvements by establishing a web site designed for children, opening up the underground vault at the Head Office's Old Building, and reviewing the contents of the public relations magazine.

In the field of financial literacy education, the Bank fully supports the activities of the Central Council for Financial Services Information (CCFSI), of which the Bank is one of the most active members. The CCFSI has been engaged in providing financial and economic information to the public, as well as assistance in improving financial literacy education. The CCFSI has announced that it will regard fiscal 2005 as the first year of promoting financial literacy education, and has been organizing projects including a festival to promote financial literacy education and a lecture series. In addition to the CCFSI's efforts, the Bank has been carrying out several of its own projects related to financial literacy education at schools—for example, seminars for schoolteachers—to promote a better understanding by the public of financial and economic issues. The Bank also plans to start an annual contest for college students from fiscal 2005.

Greater comprehension of finance and the economy, combined with more sensible decision-making in terms of expenditure on an individual basis, will ultimately contribute to fostering development of more efficient and vibrant financial markets and a more active Japanese economy. Taking these factors into account, the Bank will continue to make vigorous efforts toward public relations activities aimed at the general public and the improvement of financial literacy education.

Public Statements by the Bank of Japan

October–December 2005

October 28, 2005
Bank of Japan

Center for Monetary Cooperation in Asia (CeMCoA)

The International Department of the Bank of Japan will open the Center for Monetary Cooperation in Asia (CeMCoA) on November 11, 2005.

1. Aim

The center is aimed at promoting monetary cooperation in Asia and taking stock of information and know-how accumulated at central banks in Asia.

2. Main Activities

- To promote monetary cooperation in Asia.
- To conduct joint research on Asia within and/or together with researchers outside the central banking community.
- To strengthen technical cooperation and staff training.

3. Organization

- The center will be set up within the International Department.
- The head of the Center for Monetary Cooperation in Asia will be appointed when the center is opened.
- The center will be responsible for the functions that several separate sections now perform as listed in the attachment.

New Organization of the International Department

At present

- International Financial Cooperation
- International Institution
- Technical Cooperation
- Global Financial System
- Investment and Market Research
- US and European Research
- Asian Research
- Investment and Banking Services
- Legal Services
- Operations
- International Telecommunication
- IT Planning
- Balance of Payments Statistics
- Foreign Exchange Reporting
- BOP System
- Staff Support

From November 11, 2005

- **Center for Monetary Cooperation in Asia (CeMCoA)**
- **International Financial Cooperation (dissolved)**[1]
- Technical Cooperation[2]
- International Institution
- Global Financial System[2]
- Asian Research
- US and European Research
- Investment and Market Research
- Investment and Banking Services
- Legal Services
- Operations
- International Telecommunication
- IT Planning
- Balance of Payments Statistics
- Foreign Exchange Reporting
- BOP System
- Staff Support

Notes: *1.* Functions will be transferred to the Center for Monetary Cooperation in Asia and to the International Institution Section.
2. Some of the functions will be transferred to the Center for Monetary Cooperation in Asia.

November 9, 2005
Ministry of Finance of Japan, Bank of Japan
The Monetary Authority of Singapore

Signing of the second Bilateral Swap Arrangement between Japan and Singapore under the Chiang Mai Initiative - Second Stage

1. The Bank of Japan, acting as the agent for the Minister of Finance of Japan, and the Monetary Authority of Singapore (MAS), on November 8, signed a second bilateral swap arrangement (BSA) under the Chiang Mai Initiative (CMI) - Second Stage. The agreement will enable the two monetary authorities to swap their local currencies (i.e., Singaporean dollars or Japanese yen) against US dollars. Under the agreement, Singapore can swap up to USD 3 billion while Japan can swap up to USD 1 billion.

2. The two-way BSA is part of the CMI Second Stage which the ASEAN+3 Finance Ministers agreed to in Istanbul in May 2005. It incorporates features such as a significant increase in size from USD 1 billion to USD 3 billion from Japan to Singapore, and a new commitment of USD 1 billion from Singapore to Japan, as well as a link to the ASEAN+3 Economic Review and Policy Dialogue. The agreement also includes an increase, from 10% to 20%, in the size of swaps that can be withdrawn without tapping on an IMF-supported programme.

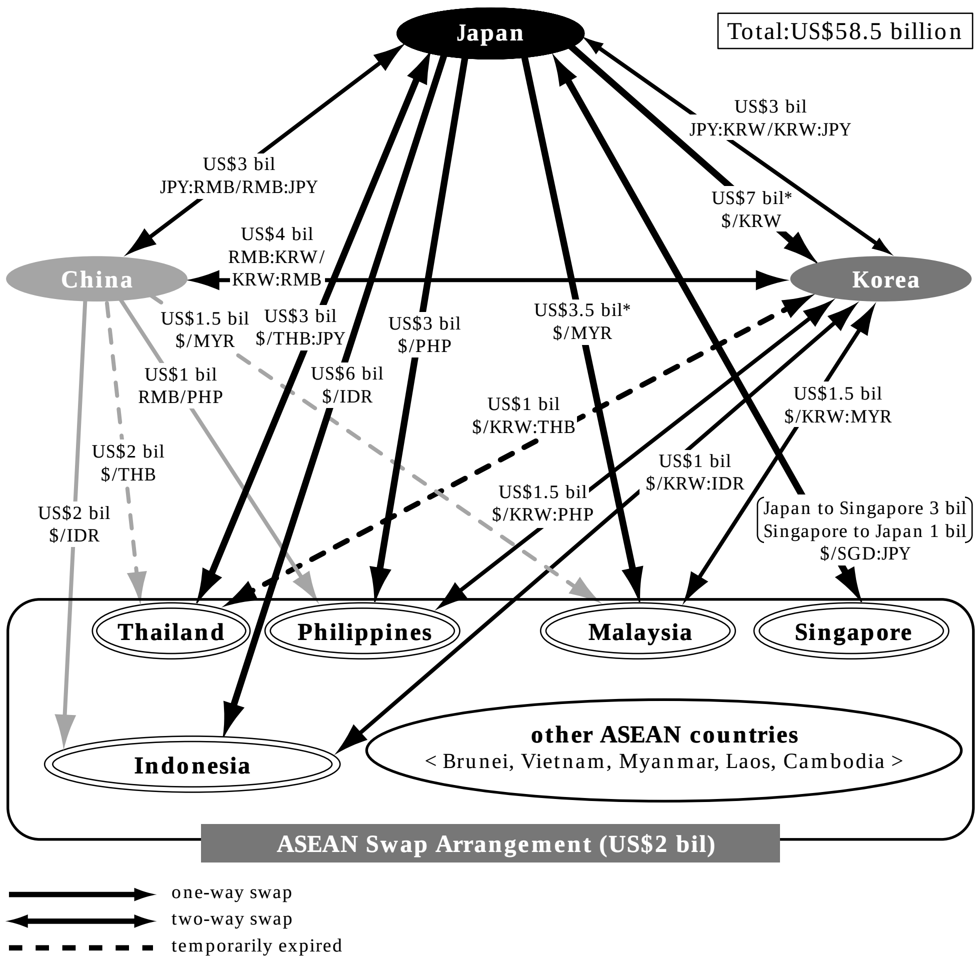
3. Mr Heng Swee Keat, Managing Director of the MAS, said, “This is a reflection of Singapore’s commitment to the financial co-operation within the ASEAN+3 Finance Ministers’ process to enhance regional financial stability.”

4. Mr Toshihiko Fukui, Governor of the Bank of Japan, said “Japan welcomes Singapore’s significant step in the CMI framework, which will lead to further enhancement of the regional financial co-operation in East Asia.”

5. Japan and Singapore concluded their first one-way BSA from Japan to Singapore amounting to USD 1 billion in November 2003.

See the annex figure.

The Agreement on the Swap Arrangement under the Chiang Mai Initiative (as of November 9, 2005)



*** Including New Miyazawa Initiative**

The agreement between Japan and Korea:	US$5 billion under the New Miyazawa Initiative
	US$2 billion under the Chiang Mai Initiative
The agreement between Japan and Malaysia:	US$2.5 billion under the New Miyazawa Initiative
	US$1 billion under the Chiang Mai Initiative

Note: Total amount does not include New Miyazawa Initiative and ASEAN swap arrangement.

December 2, 2005
Bank of Japan

Proposal for the Next-Generation RTGS Project of the BOJ-NET Funds Transfer System

On November 29, 2005, the Bank of Japan released a consultation document on the proposal for the next generation of the BOJ-NET Funds Transfer System (available in Japanese only).[1,2]

In the consultation document, the Bank proposes to implement two measures with a view to further enhancing the safety and efficiency of large-value payment systems in Japan. First, the Bank will introduce liquidity-saving features into the real-time gross settlement (RTGS) mode of the BOJ-NET Funds Transfer System. Second, the Bank will modify the BOJ-NET Funds Transfer System in order to incorporate large-value payments that are currently handled by two private-sector deferred net settlement systems into the new RTGS system with liquidity-saving features. The two measures proposed by the Bank are collectively referred to as the next-generation RTGS (RTGS-XG) project.

The BOJ-NET Funds Transfer System serves as the core payment system in the Japanese financial system, and therefore the implementation of the RTGS-XG project will have a wide impact on financial institutions' daily operations and trading practices in relevant markets. This means that, in order to fully achieve its objectives, the project will require the individual and cooperative efforts of the Bank, BOJ current account holders, and other relevant parties in making modifications to systems and procedures at each institution and in reviewing market practices. Such efforts will also require development of a common understanding of the benefits of the RTGS-XG project and a shared vision of the future landscape of payment systems in Japan.

The Bank invites comments from interested parties on the consultation document by January 18, 2006.

1. The original version in Japanese can be accessed at the Bank's web site (http://www.boj.or.jp/index.html).
2. An overview of the Bank's proposal in English can be accessed at the Bank's web site (http://www.boj.or.jp/en/index.htm).

Information about the Bank's Web Site

- Renewal of the Bank of Japan Web Site
- The Bank of Japan E-Mail Service
- Speeches and Research Papers

Renewal of the Bank of Japan Web Site

With the aim of further enhancing web site usability, the Bank of Japan will renew its web site. The following are the main features of the new web site (the URL will remain the same: http://www.boj.or.jp/en/index.htm).

Major Improvements

• A more user-friendly web site design
• Easier-to-search content structure

New Content Structure

The new site provides the following basic ways to access the information you need.

(a) **About the Bank**
This provides basic information about the Bank of Japan, such as an overview of its organization and roles, as well as the Bank of Japan Law.

(b) Search by category
—**Policy and Operations**
Information is sorted by policy and operations conducted by the Bank. In addition to the eight basic categories of the Bank's policy and operations, there is a category on the Bank's business continuity planning.
—**Index by Document Type**
Information is sorted by document type, such as "Speeches and Statements," "Research Papers," and "Statistics."

(c) A section useful for accessing the necessary statistics right away
—**Navigating the Bank's Statistics**
This gives users a hint as to where various statistics and data are located and how to make the best use of them. Users can directly access major statistics from this menu.

The Bank of Japan E-Mail Service

We have an e-mail service to notify you when new information is uploaded on the Bank of Japan's web site. If you wish to receive this service, please register your e-mail address at the English version of the Bank's web site (http://www.boj.or.jp/en/index.htm). Users who have already registered to receive the Bank of Japan E-Mail Service do not need to re-register to continue the service. However, due to the extensive changes to the web contents, the "Category/Categories of Information Requested," in use up to the time of the renewal, will be unified.

Speeches and Research Papers

Speeches and research papers released on the Bank's web site between November 2005 and January 2006 are listed below. To reach the documents through the Internet, access the Bank's web site (http://www.boj.or.jp/en/index.htm).

Title	Speaker	Venue	Date of speech	Date of release
■ Speeches/Summaries of Speeches by Bank Executives				
Toward a New Path of Growth for the Japanese Economy[1]	Toshihiko Fukui (Governor)	Kisaragi-kai Meeting (Tokyo)	November 11, 2005	November 11, 2005
Statement before the House of Councillors[1]	Toshihiko Fukui (Governor)	Committee on Financial Affairs (Tokyo)	October 18, 2005	November 21, 2005
Recent Economic and Financial Developments in Japan	Toshikatsu Fukuma (Member of the Policy Board)	Meeting with Business Leaders (Fukui)	September 14, 2005	December 8, 2005
Speech in Nagoya[1]	Toshihiko Fukui (Governor)	Meeting with Business Leaders (Nagoya)	December 8, 2005	December 8, 2005
Price Stability and Central Banks' Responsibility[1]	Toshiro Muto (Deputy Governor)	Keizai Club (Tokyo)	December 2, 2005	December 29, 2005
The Current Situation and Outlook for Japan's Economy[1]	Toshihiko Fukui (Governor)	Board of Councillors of Nippon Keidanren (Japan Business Federation) (Tokyo)	December 22, 2005	January 12, 2006

Title	Author(s)	Category	Date of release
■ Bank of Japan Research Papers/Working Paper Series[2]			
The Improvement in Corporate Earnings and Its Implications for the Japanese Economy	Research and Statistics Department	Research Papers	November 10, 2005
Trade Patterns in Japan's Machinery Sector	Hitoshi Sasaki and Yuko Koga	Working Paper Series	December 7, 2005
Public Relations Activities of the Bank of Japan and Its Approaches to Financial Literacy Education[3]	Public Relations Department	Research Papers	December 28, 2005
The Expansion of Corporate Groups in the Financial Services Industry: Trends in Financial Conglomeration in Major Industrial Countries[3]	Financial Systems and Bank Examination Department	Research Papers	December 28, 2005

Notes: 1. Published in the *Bank of Japan Quarterly Bulletin*.
2. The Bank introduced the series to invite comments on working papers written by the Bank's staff and outside researchers.
3. A summary of the paper is published in the *Bank of Japan Quarterly Bulletin*.