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Minutes of the Monetary Policy Meeting on April 7 and 8, 2003

Bank of Japan/Central Bank of Japan

The Bank of Japan is the central bank of Japan.

日本銀行 BANK OF JAPAN

Monetary Policy

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on April 7 and 8, 2003
(English translation prepared by the Bank's staff based on the Japanese original)

May 23, 2003
Bank of Japan

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, April 7, 2003, from 2:00 p.m. to 3:52 p.m., and on Tuesday, April 8, from 9:00 a.m. to 1:17 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
Mr. K. Ueda
Mr. T. Taya
Ms. M. Suda
Mr. S. Nakahara
Mr. H. Haru
Mr. T. Fukuma

Government Representatives Present
Mr. T. Taniguchi, Senior Vice Minister of Finance, Ministry of Finance[2]
Mr. H. Tsuda, Deputy Vice Minister for Policy Planning and Coordination, Ministry of Finance[3]
Mr. H. Takenaka, Minister of State for Economic and Fiscal Policy, Cabinet Office[4]
Mr. Y. Kobayashi, Vice Minister for Economic and Fiscal Policy, Cabinet Office[5]

Reporting Staff
Mr. E. Hirano, Executive Director (Assistant Governor)
Mr. M. Shirakawa, Executive Director
Mr. A. Yamamoto, Executive Director
Mr. H. Yamaguchi, Adviser to the Governor, Policy Planning Office
Mr. T. Wada, Deputy Director-General, Policy Planning Office[6]
Mr. S. Kushida, Director, Head of Planning Division I, Policy Planning Office
Mr. K. Yamamoto, Director-General, Financial Markets Department

Mr. H. Nakaso, Deputy Director-General, Financial Markets Department[6]
Mr. H. Hayakawa, Director-General, Research and Statistics Department
Mr. K. Momma, Director, Head of Economic Research Division, Research and Statistics Department
Mr. A. Horii, Director-General, International Department

Secretariat of the Monetary Policy Meeting
Mr. Y. Hashimoto, Director-General, Secretariat of the Policy Board
Mr. Y. Nakayama, Adviser to the Governor, Secretariat of the Policy Board
Mr. H. Onobuchi, Deputy Director, Secretariat of the Policy Board
Mr. S. Shimizu, Senior Economist, Policy Planning Office
Mr. S. Nagai, Senior Economist, Policy Planning Office

1 The minutes of this meeting were approved by the Policy Board at the Monetary Policy Meeting held on May 19 and 20, 2003 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. Taniguchi was present on April 8.

3 Mr. Tsuda was present on April 7.

4 Mr. Takenaka was present on April 8 from 10:41 a.m. to 12:46 p.m.

5 Mr. Kobayashi was present on April 7 for the whole of the session, and on April 8 from 9:00 a.m. to 10:28 a.m.

6 Messrs. Wada and Nakaso were present on April 8.

I. Summary of Staff Reports on Economic and Financial Developments[7]

A. Money Market Operations in the Intermeeting Period

The Bank conducted market operations in accordance with the guideline decided at the previous meeting on March 25, 2003.[8] It aimed higher than the ceiling of the target range to secure financial market stability, given that military action against Iraq continued. As a result, the outstanding balance of current accounts at the Bank stood at 30.9 trillion yen on March 31, and it increased further to 33.8 trillion yen on April 1 partly reflecting the establishment of Japan Post. Thereafter, it had recently decreased to around 27-28 trillion yen as demand for funds maturing beyond the fiscal year-end subsided.

As a result of the above operations, the weighted average of the uncollateralized overnight call rate remained at 0.001 percent, except on March 31, when it was 0.021 percent.

B. Recent Developments in Financial Markets

Money market rates overall continued to be stable due to the Bank's provision of more ample liquidity, despite the fact that Japanese stock prices were weak and the United States and other nations had started taking military action against Iraq. Three-month Euro-yen rates declined further from the beginning of the new fiscal year, recording a historical low. Yields on financing bills and treasury bills declined in the intermeeting period, but the pace of decline was moderate due to the continued increase in their issuance.

Japanese stock prices continued to reflect market participants' nervousness about developments in Iraq. Market concern about Japan's financial system remained strong, as reflected in the decline in bank stocks, and recovery of stock prices in Japan was moderate compared with overseas.

Long-term interest rates in Japan declined continuously from the middle of March, in marked contrast to the rebound in the United States and Europe. In particular, yields on longer-than-ten-year Japanese government bonds (JGBs) in the secondary market fell rapidly. This was because institutional investors increased investment in them ahead of their initial plans for fiscal 2003, against the background of a strong sense of excess liquidity and the persistence of considerable uncertainty about the economic outlook.

The U.S. dollar continued to depreciate, especially against the euro, reflecting concern about a further expansion in fiscal deficits and the current account deficit in the United States.

C. Overseas Economic and Financial Developments

The U.S. economy had stayed on a modest recovery trend, but the momentum for an increase in production, employment, and income was weakening.

Regarding developments in U.S. final demand, private consumption remained on a moderate upward trend. However, the effects of the deterioration in the employment situation and a further worsening of consumer confidence gave cause for concern. Housing investment remained firm reflecting lower mortgage interest rates, but the pace of increase in housing prices was slowing. Business fixed investment was judged to have stopped declining. However, due to the persistence of uncertainty about the outlook for corporate profits, there had been no sign that business fixed investment was on a recovery trend. In this situation, the pace of recovery in production remained sluggish. Indexes compiled by the Institute for Supply Management (ISM) for March in the manufacturing sector fell below 50 percent, the break-even point between improvement and deterioration in business conditions, due to the decline in the indexes of new orders and production.

In U.S. financial markets, long-term interest rates and stock prices fluctuated widely reflecting speculation regarding developments in the military action against Iraq. Judging from developments in federal funds rate futures, market participants continued to expect a cut in the target for the federal funds rate by around the middle of 2003, although expectations observed in early March of a cut in the very near future had abated.

In the euro area, the economy was decelerating, especially in Germany, since domestic demand components, such as private consumption and business fixed investment, remained sluggish and exports were slowing. Leading indicators of exports and production in the euro area, such as orders received from abroad in Germany and the Purchasing Managers' Index (PMI), were sluggish. The employment situation in the area continued to deteriorate moderately, and consumer confidence was also declining.

NIEs and ASEAN economies stayed on a recovery trend. Domestic demand components, such as private consumption and business fixed investment, remained firm, although the pace of increase in exports, especially of IT-related goods, slowed slightly. In China, economic growth remained high due to an uptrend in exports in addition to strong domestic demand supported by an increase in fiscal spending and large direct investment from abroad.

Financial markets in emerging economies were stable overall. This was because indigenous destabilizing factors had eased slightly, especially in Latin America, although unstable developments were observed in some other economies such as South Korea and Turkey. In East Asian economies, stock prices in Hong Kong and Taiwan were declining due to concerns about the spread of severe acute respiratory syndrome (SARS).

D. Economic and Financial Developments in Japan

1. Economic developments

Net exports remained virtually level, with both exports and imports increasing at a very modest pace. A breakdown of exports by region indicated that exports to the United States declined considerably, while those to East Asia continued to increase against the background of firm domestic demand in the region and structural factors such as the progress in international division of the production process between Japan and other East Asian economies. As for the outlook, the increase in real exports was expected to remain very modest for a while because recovery in the U.S. and European economies was likely to be very weak, at least for the time being, although Asian economies, particularly China, were likely to remain firm.

With regard to domestic demand, although housing investment remained sluggish and public investment was on a declining trend, business fixed investment had started to recover. Regarding the outlook, business fixed investment was likely to gradually start to follow a clear uptrend against the background of improvement in corporate profits, as suggested by leading indicators of business fixed investment and the March Tankan (Short-Term Economic Survey of Enterprises in Japan). However, the pace of increase was likely to remain very modest, given the substantial uncertainty about the outlook for overseas economies in addition to various structural factors.

As for private consumption, many sales indicators picked up in January and February 2003 after declining in December 2002. On the whole, there was no distinct change in the underlying trend of private consumption. Private consumption was expected to remain sluggish overall for the time being, given that the employment and income situation was likely to remain severe and some indicators of consumer sentiment were weak.

Production seemed to have increased slightly in the January-March quarter of 2003 after it inched down by 1.0 percent in the October-December quarter of 2002 on a quarter-on-quarter basis. Overall, production remained virtually level. Inventories were at low levels, reflecting the cautious stance of firms on production. Although production was unlikely to regain momentum, the risk of a vicious circle of production cuts stemming from adjustment pressure on inventories seemed small.

As for the employment and income situation, the number of new job offers was on a gradual rising trend, and the number of employees in the Labour Force Survey, which covered various types of employees including non-regular employees such as temporary workers, appeared to be declining at a slower pace. However, the employment and income situation overall remained severe because wages continued to decline and the number of regular employees continued to fall reflecting firms' stance of continuously reducing personnel expenses.

On the price front, import prices were rising, reflecting the rise in prices of international commodities such as crude oil. Prices of a wide range of domestic commodities had been rising, reflecting the upward trend in crude oil prices and tightening of the supply-demand balance of raw materials such as steel and chemicals. Consumer prices had been declining gradually, but the pace of year-on-year decline was expected to slow very gradually. This was partly because firms were becoming less inclined to continue their low-price strategy, crude oil prices were high, and the burden on households of medical costs increased from April due to public insurance reforms.

2. Financial environment

With regard to credit aggregates, private banks' lending continued to decline by 2-3 percent on a year-on-year basis. The amount outstanding of funds raised through issuance of CP and corporate bonds was generally moving at around the previous year's level. The total amount of funds raised by the private sector continued to follow a downtrend.

As for monetary aggregates, the year-on-year growth rate of the monetary base was about 10 percent. This was because the outstanding balance of current accounts at the Bank continued to grow by 30-40 percent, while the growth rate of banknotes continued to decline reflecting the significant increase in the same month of the previous year against the background of the partial removal of blanket deposit insurance. The year-on-year growth rate of the money stock was around 2 percent. That of broadly-defined liquidity was about 1 percent.

In corporate financing, credit demand in the private sector continued to follow a downtrend, as business fixed investment remained sluggish and firms continued to reduce their debts.

Private banks remained cautious in extending loans to firms with high credit risk, while on the other hand they continued to be more active in extending loans to blue-chip firms. Recently, however, banks that had received an injection of public funds seemed to have gradually become willing to lend to small firms, in line with the "Business Improvement Administrative Order." The lending attitude of financial institutions as perceived by firms either remained unchanged or improved slightly in the March Tankan, and the survey by the Japan Finance Corporation for Small Business showed that it continued to improve. However, in both surveys, the proportion of firms perceiving the lending attitude of financial institutions as "severe" remained large.

Credit spreads in the CP market remained stable overall at the turn of the fiscal year, although they widened somewhat when banks became slightly cautious about underwriting CP issued by firms with low credit ratings such as A-2. Credit spreads at issuance on corporate bonds were also stable overall.

The financial environment had been stable overall since the previous meeting, without any significant disruption around the fiscal year-end, despite negative factors such as the military action against Iraq and the weakness of Japanese stock prices, particularly bank stocks. However, developments in financial markets, the behavior of financial institutions, and the corporate financing situation continued to require close monitoring.

7 Reports were made based on information available at the time of the meeting.

8 The guideline was as follows:
Until March 31, the Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 15 to 20 trillion yen. From April 1, considering necessary adjustment due to the establishment of the Japan Post, the Bank will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 17 to 22 trillion yen.
For the time being, given that significant uncertainty including geopolitical risks is likely to persist, the Bank will provide more liquidity irrespective of the above target when necessary to secure financial market stability.

II. Summary of Staff Reports Based on the Chairman's Instructions at the Previous Meeting

The staff made a report based on the following instructions given by the chairman at the previous meeting. First, in order to further examine the basic framework for the conduct of monetary policy, the staff should examine a wide range of issues related to enhancement of monetary policy transparency and strengthening the monetary policy transmission mechanism based on the experience of quantitative easing so far. And second, in particular, the staff should explore possible measures to strengthen the transmission mechanism of monetary easing in the areas of corporate finance and money market operations and report back as soon as possible.

A. Economic and Financial Developments under the Quantitative Easing Framework

Looking back at economic and financial developments since the Bank started to employ the quantitative easing framework in March 2001, the effects of the ample provision of liquidity by the Bank had not permeated throughout the economy, and it had not adequately stimulated economic activity nor pushed up prices. The growth in the money stock was sluggish and banks' lending was decreasing, despite the high growth in the outstanding balance of current accounts at the Bank and in the monetary base. On the other hand, quantitative easing measures had been effective in ensuring the stability of financial markets in a situation where there were various financial market stresses, such as anxiety about the stability of the financial system, and these measures had prevented concern about banks' business condition from spreading and corporate finance from deteriorating as a result. Thus, quantitative easing measures had prevented the economy from falling into a deflationary spiral.

Short-term interest rates had been stable at low levels and medium- to long-term interest rates had generally followed a downward trend under the quantitative easing framework. On the other hand, developments in asset prices suggested that financial institutions and investors were not investing actively so far. Stock prices continued to decline, and the yen appreciated slightly against the U.S. dollar after depreciating through the beginning of 2002.

In the money market, quantitative easing had had some negative side effects: for example, the functioning of the money market had been weakened as seen in a diminishing volume of transactions among market participants as a result of the significant decline in interest rates.

B. Issues Related to Enhancing the Transparency of Monetary Policy

The following process would be important in ensuring the transparency of monetary policy. First, the Bank should present to the public the objective which it aimed to achieve through monetary policy. Second, it should present its assessment of the current economic and financial developments and the outlook for the economy. And third, based on the objective and the assessment, it should make clear the thinking and discussions behind its decisions on monetary policy.

The issues related to enhancing the transparency of the objective of monetary policy were as follows. First, whether the Bank's stance that price falls were not desirable had permeated throughout the public and financial markets. And second, whether means of conveying the Bank's stance of achieving price stability could be improved, giving due consideration to avoiding misunderstanding about the conduct of monetary policy.

Regarding the issues related to enhancing the transparency of the assessment of the economic and financial situation, the forecast of the outlook for the economy was important given the time lag between implementation of monetary policy and the materialization of its effects. The staff pointed out the following issues. First, whether there was room for further improving the content of the semiannual report "Outlook and Risk Assessment of the Economy and Prices" (hereafter the Outlook Report). And second, how the Bank could increase the clarity of the Policy Board's forecast of the economy and prices while at the same time respecting diversity in the individual forecasts of the nine members, which was important for the discussion at Monetary Policy Meetings where decisions were made by majority vote.

The issues related to enhancing the transparency of the monetary policy formulation procedure were as follows. First, whether the Bank explained appropriately to the public the reasons for adopting or rejecting a policy measure in relation to the Bank's assessment of the economy and possible risks attached to policy options which might materialize in the future. And second, whether the Bank could further improve its ways of explaining the thinking behind its conduct of monetary policy including its decision whether to adopt certain policy measures.

C. Issues Related to the Bank's Money Market Operations

The Bank's basic aim in conducting money market operations was to maximize the effects of monetary policy through the mechanism of financial markets. It was, therefore, necessary to consider the following points when devising new market operations, although they were not so much of a concern in a normal economic and financial environment. First, what transmission mechanism could be expected to operate. Second, whether the market operation might hamper the proper functioning of the market mechanism, whether it was neutral for allocation of resources, and whether it could contribute to the development of financial markets. And third, whether the market size of the financial assets used in the market operation was large enough for the Bank's operation.

In conducting market operations it was also important to maintain the soundness of the Bank's financial condition. Therefore, the Bank should make efforts to maintain an appropriate level of capital, taking into account various risks and securing the liquidity of its financial assets as a whole, in order to maintain its ability to conduct monetary policy in the future.

D. Proposal for a New Scheme to Promote Smooth Corporate Financing by Nurturing the Market for Asset-Backed Securities (ABSs) Including Asset-Backed Commercial Paper (ABCP)

As a possible measure to strengthen the transmission mechanism of monetary easing in the areas of corporate finance and money market operations, the staff would like to propose a new scheme to promote the development of the market for ABSs backed by assets related to small and medium-sized firms. In the new scheme, the pools of assets backing ABSs comprised mainly loans to and receivables purchased from small and medium-sized firms, and ABSs were categorized into multiple layers according to the degree of risk.

The merits of ABSs were that the overall level of credit risk was reduced by pooling of individual backing assets, and ABSs could restructure the overall risk of the backing assets to produce several types of securities according to investors' risk-taking capacity. By supplementing the current weak financial intermediary function of banks, the development of the market for ABSs was expected to promote smooth corporate financing in the following respects. First, the funding capability of small and medium-sized firms would be enhanced, and banks' lending capacity would be reinforced. And second, an increase in the market liquidity of ABSs would reduce funding costs and increase the availability of funds for small and medium-sized firms. Thus, a new financing channel for firms, particularly small and medium-sized firms, would be promoted, and the transmission mechanism of monetary easing would be strengthened as a result.

The market for ABSs backed by assets related to small and medium-sized firms was currently marginal due to banks' and investors' capital constraints and the market's underdeveloped infrastructure. In order to promote the development of the ABS market, the Bank could encourage the development of new arrangements of ABSs with multiple layers according to the degree of risk and, as a temporary measure, the Bank or other public institutions could purchase securities, and such purchases could include mezzanine securities, which did not have a sufficient number of private buyers in the current situation.

In devising the new scheme, the staff considered it appropriate to seek comments on the Bank's proposal from market participants, given that the ABS market was still in the process of development.

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

On the current state of Japan's economy, members agreed that economic activity remained flat as a whole. This was because, while corporate profits continued to recover and business fixed investment was starting to recover, there was greater uncertainty about the economic outlook reflecting the unpredictability of developments overseas, especially in Iraq, and unstable Japanese stock prices, particularly bank stocks.

Many members expressed the view that the above assessment of the economy was confirmed in the March Tankan.

Members concurred that exports continued to show moderate growth, partly reflecting the firmness in Asian economies, and production continued to be basically level.

With regard to domestic private demand, members agreed that corporate profits continued to recover reflecting the improvement in exports and production. The March Tankan also suggested that corporate profits were likely to increase in fiscal 2003 as in fiscal 2002.

Members concurred that business fixed investment was starting to recover. One member said that, in the manufacturing industry, a positive chain reaction of business fixed investment could start from electrical machinery. However, some members expressed a cautious view of the outlook for business fixed investment, saying that the momentum for recovery and the sustainability of the recovery continued to be vulnerable. One of these members pointed out that business fixed investment was likely to follow a clear uptrend but would continue to be under downward pressure from structural factors, such as the decline in the expected rate of return, the burden of excessive debts, and the shift of manufacturers' production to overseas locations.

As for the household sector, many members said that many indicators of private consumption picked up in January and February 2003 after deteriorating in December 2002. Overall, private consumption remained weak. One member pointed to the effects of demographic changes and households' accumulation of liquid assets and cash as the reason why private consumption had been holding up relatively well considering the severity of the income situation.

Many members said that the employment and income situation remained severe. However, one member said that there were an increasing number of positive developments that gave grounds for thinking that the deterioration in the employment and income situation would start to moderate. A different member pointed out that nominal wages had almost stopped falling on a year-on-year basis in February, and said that, although a rise in household income was unlikely with the continued fall in the number of employees, the fall in household income could be expected to come to a halt as firms' business performance recovered.

With respect to the economic outlook, most members said that, assuming that overseas economies recovered gradually, there was no need to change the basic scenario of an increase in exports and production generating the momentum for a recovery. This was partly because positive developments were increasing recently, for example, business fixed investment was starting to recover.

However, most members said that the uncertainty of the economic outlook was becoming stronger due mainly to the following risk factors: an increase in weak indicators in overseas economies suggested that the outlook for them was uncertain; and Japanese stock prices, particularly bank stocks, were unstable.

Many members were concerned that, although the U.S. economy remained on a modest recovery trend, some indicators of private consumption were somewhat weak reflecting deterioration in consumer sentiment and indicators related to production and employment were deteriorating. Some members expressed the view that the weakening of these economic indicators might not stem from the military action against Iraq, but rather, from the vulnerability of the economic structure of the United States, which was already present before the military action started. Many members commented on the risks arising from the situation in Iraq and said that the following factors were becoming the main causes of uncertainty. First, how stability would be secured in the Middle East after the war. Second, how the fiscal burden borne by the U.S. government in assisting in the reconstruction of Iraq would affect the "twin deficits." And third, how these factors would affect the exchange rate of the U.S. dollar.

As for overseas economies other than the U.S. economy, most members raised the effects of SARS on Asian economies as a new risk factor, although the magnitude of the impact was not certain yet. A few members were cautious about the outlook for European economies, pointing to fiscal deficits, unemployment, and the weakness in the financial sector especially in Germany.

Most members pointed out unstable stock prices, particularly the fall in bank stocks, as a major risk factor in the future. These members pointed out the risk that the fall in stock prices would negatively affect corporate financing and the economy as a whole through the financial system. One of these members said that the current condition of the financial system was not severe as it had been in 1998 when concern about financial system stability heightened, but the fact that the outstanding balance of current accounts at the Bank remained at around 30 trillion yen indicated its potential vulnerability.

With regard to future developments in stock prices, one member said that major banks were becoming less vulnerable to stock price falls, but stocks were still under considerable selling pressure due, for example, to unwinding of cross-shareholdings, reduction in stock holdings of life insurance companies, and the change in some employees' pension fund schemes. On the other hand, a different member said that market participants were hesitant about buying Japanese stocks because of various uncertainties, but they might start to increase their purchases because valuation indexes suggested that stocks were undervalued, the taxation on securities transactions had been reviewed, and corporate profits were improving.

Members agreed that, although there was no disruption in the money market at the turn of the fiscal year due partly to the Bank's provision of ample liquidity, market developments continued to require monitoring and it was necessary that the Bank continue to secure availability of funds for financial institutions. This was because geopolitical developments were uncertain and Japanese stock prices were unstable. One member pointed out that long-term interest rates had been on a steadily declining trend despite various speculations about the situation in Iraq, and said that this was mainly because banks and institutional investors were feeling very strongly that there was excess liquidity in financial markets.

One member expressed the view that prices were unlikely to start increasing on a year-on-year basis, although the pace of decline was expected to slow for the time being due to several supply-side factors. A different member agreed with this view.

In relation to the above, members discussed the assessment of the expected inflation rate and the real interest rate. One member said that the real interest rate was decreasing slightly given that the expected inflation rate, or the expected deflation rate, was close to the actual inflation rate. Therefore, the member considered that the risk of the economy immediately falling into a deflationary spiral was not very high. A different member said that the real interest rate must have declined considerably since 1999, because the nominal interest rate had fallen by more than 1 percent while the pace of change in the GDP deflator had been almost the same. This member continued that, because the real interest rate had been on a declining trend since the 1980s in Japan, and had also been declining in the United States, the real interest rate differentials between Japan and the United States were stable. The member pointed out that, in judging the level of the real interest rate, it was important to assess its trend movements and compare its developments with those in other countries.

Against this view, a different member said that deflation had been accelerating, as evident in the fact that, compared with 1995, the pace of year-on-year decline in the GDP deflator had accelerated, recently reaching over 2 percent, and the deflator for business fixed investment had declined by about 4 percent.

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

On the monetary policy stance for the immediate future, the majority of members agreed that it was appropriate to maintain the current target range of "around 17 to 22 trillion yen" for the outstanding balance of current accounts at the Bank, in view of the following factors. First, the present situation required no change in the assessment of the economy as remaining flat, given that business fixed investment was starting to recover recently although the uncertainty about the outlook was becoming stronger. And second, the overall money market was stable due to the Bank's provision of ample liquidity.

Most members agreed that it was appropriate to continue providing ample liquidity to the money market in line with the present contingency clause of the guideline for money market operations. This was because there was still the risk that the market might become unstable, although there was no disruption in the market at the turn of the fiscal year and expectations were increasing that the military action against Iraq would be short. One member considered it important to explain the thinking behind this decision to maintain the current target range carefully to the public in order to avoid possible misunderstanding that the outstanding balance of current accounts at the Bank would soon fall back to 22 trillion yen, the ceiling of its target range.

Against this majority view, one member said that it was natural and realistic to raise the target range for the outstanding balance of current accounts at the Bank to "around 25 to 30 trillion yen" to clearly indicate the Bank's strong determination to continue quantitative easing. The Bank's policy needed to be consistent with the fact that it had been providing ample funds to an amount exceeding the ceiling of the target range since the beginning of March 2003 and that it considered it necessary to continue to do so for the time being. This member expressed the view that the target range should be changed back to the current target of "around 17 to 22 trillion yen" when factors creating uncertainties for Japan's economy had passed. Against this view, however, a few members said that a decision to change the target range back could cause misunderstanding of the Bank's policy intention, and thus this was not a plausible option for the Bank.

As for the Bank's future conduct of monetary policy, a different member commented that it should also consider the issue of increasing the outstanding balance of current accounts at the Bank in order to maintain the year-on-year growth rate of the monetary base.

In relation to specific measures to strengthen the monetary policy transmission mechanism, members mainly discussed the scheme to promote smooth corporate financing by nurturing the market for ABSs including ABCP that was presented by the Bank's staff.

Members agreed that, given that banks' financial intermediary function was weak, it would be desirable to encourage development of the market for ABSs backed by assets related to small and medium-sized firms, in order to strengthen the transmission mechanism of monetary easing. One member pointed out the merits of promoting the development of the ABS market as follows. First, a new financing channel for small and medium-sized firms would be promoted with the development of the primary market. And second, credit risk would be priced more appropriately due to participation of a wide range of investors in the secondary market. A different member added as another advantage that banks could release part of their capital that had been allocated to loans to small firms by selling some of them. One member pointed out that inter-company credit, particularly for small firms, had declined considerably in the previous year, and said that there was an immediate need to diversify and strengthen small firms' financing channels.

Some members said that, even if the new scheme worked properly, the transmission mechanism of monetary easing would not be much strengthened because the ABS market was small. One member said that, for the time being, households and firms would continue to be financial surplus sectors and would continue to reconstruct their balance sheets through the market mechanism. In this situation, banks needed to improve their capital adequacy ratios by ceasing to rely heavily on lending financed by accepting deposits. Therefore, it was unlikely that introduction of the scheme would stimulate lending to small and medium-sized firms and increase the money supply, and the Bank should not create expectations in the public that such effects could be realized. A different member said that, given the size of the ABS market, the scheme could not play a significant role in money market operations and the introduction of the scheme would not greatly strengthen the transmission mechanism of monetary easing. Therefore, in explaining to the public the Bank should emphasize its policy intention of promoting the development of the ABS market.

Members next discussed, from various perspectives, possible effects and the appropriateness of outright purchases by the Bank of ABSs in its money market operations.

A few members said that among the points raised by the Bank's staff for consideration when devising new market operations-the expected transmission mechanism, the compatibility with the functioning of the market mechanism, and the market size of the financial assets used in the operation-the transmission mechanism was the most important in the present economic situation.

Some members said that outright purchases by the Bank of assets with credit risk would be a considerable departure from previous policy regarding market operations, and it was necessary to examine thoroughly why ABSs backed by assets related to small and medium-sized firms should be chosen as operational instruments above other assets. In response to this, one member commented that it was difficult to compare and examine all possible options simultaneously when deciding monetary policy, and thus the Bank would have to take the approach of examining options that were likely to be feasible as they emerged. The member continued that the Bank should press forward with examination of the scheme of outright purchases of ABSs by seeking comments from market participants.

One member explained the reasons why the Bank should depart from its previous policy regarding market operations and start outright purchases of ABSs backed by assets related to small and medium-sized firms. First, there was almost no other effective option to broaden the range of eligible collateral. Therefore, as the next step, the Bank would have to start purchasing private credit. Second, ABSs would be less linked to individual entities and thus more neutral than other types of private credit. And third, credit risk would be reduced by pooling individual backing assets, and more accurate calculation and evaluation of credit risk would become possible. In response to this, a different member pointed out that, although individuality linked to assets backing ABSs could be reduced to a certain extent by pooling them, the structure of ABSs lacked uniformity, and therefore, the problem remained of the Bank's possible involvement in a thin and segmented market.

Members agreed that, when examining the new scheme, the Bank should give due consideration to how it would secure the soundness of its financial condition. One member warned that if the Bank were not able to prove the soundness of its financial condition clearly to the public, its credibility and the effectiveness of policy could decline. Another member noted that if the Bank intended to take on the credit risk of small and medium-sized firms, an internal system of managing credit risk should be established and various databases and other information sources should be utilized.

A different member said that the following basic features of the Bank's capital should be fully understood. First, seigniorage, the profit generated by issuing banknotes, belonged to the public, and it should be used for the conduct of fiscal policy upon approval by the Diet as part of the budget. Second, the Bank kept part of the seigniorage in its capital basically as part of the reserve for dealing with possible materialization of unexpected risk when it exercised the lender of last resort function. And third, the Bank could allocate any remaining capital for the conduct of a particular policy. Based on this understanding, this member continued that the possibility that the Bank might have to increase its holding of JGBs depending on the future economic situation meant that the current amount of the Bank's capital could not be considered sufficient for the above purposes. In this situation, if the Bank were to take bold action to purchase risk assets, this might create market concern that the Bank would not be able to allocate sufficient capital to purchase other risk assets. Meanwhile, the financing situation of small firms remained severe but was not tightening further. The member noted that, in view of the above factors, of the multiple layers of ABSs, the Bank might consider it suitable to adopt a policy of purchasing only senior securities and accepting mezzanine securities as eligible collateral.

Many members agreed that the Bank's proposed participation in fostering markets by taking on credit risk would inevitably cause the Bank to enter the domain of fiscal policy. One member said that it would therefore be important to cooperate with relevant government institutions in addition to market participants in fostering markets.

Most members agreed that the Bank's involvement in fostering markets should be temporary and at the minimum level in order to avoid market distortion and creation of moral hazard. One member expressed the view that if it were decided that the Bank should not only purchase ABSs but also sell some of them in the market, this would improve the price-discovery function of the market, thereby contributing to its development. Another member said that the Bank should promote price formation by a large number of market participants at the earliest stage possible and reduce its presence as a purchaser in the market.

One member expressed concern regarding the proposed scheme that securitization of banks' loans might face difficulty as spreads on loans and other financial claims backing ABSs were small.

Many members commented on the procedure for examining the scheme by seeking public comments from market participants. They expressed the view that, given that the market was still undeveloped, it was appropriate to communicate with market participants and examine the scheme to determine how the Bank could be involved in the most effective way and with the least distortion of the market mechanism. However, one member expressed the view that the procedure could be a double-edged sword because, while the Bank could utilize the private sector's expertise, there was a possibility that the comments received from market participants might be excessively diverse. A different member said that seeking public comments was an unusual procedure to employ in formulating a new measure for market operations.

Based on the above discussion, most members agreed that the Bank should proceed with examination of the scheme proposed by the Bank's staff-the scheme for smooth corporate financing by nurturing the market for ABSs backed mainly by assets related to small and medium-sized firms-by seeking comments from market participants, although the details of the scheme needed to be considered further.

Some members commented that the Bank should examine further not only the proposed scheme but also whether other measures could be employed to strengthen the transmission mechanism of monetary easing through smooth corporate financing. One member stressed that, for the effects of quantitative monetary easing measures to permeate throughout the economy, top priority should be given to encouraging recovery of the financial intermediary function of banks by accelerating the disposal of nonperforming loans (NPLs).

Regarding the basic framework for the conduct of monetary policy, members discussed issues related to enhancing the transparency of monetary policy.

One member commented that the Bank's commitment to continue the current quantitative easing framework until the consumer price index registered stably zero percent or an increase year on year could cause misunderstanding that the Bank was aiming for an increase in the inflation rate of around zero to 1 percent. The Bank could, in addition, devise measures to make it clear that it took a broader view of the meaning of price stability. However, if the Bank were to express price stability in terms of numerical values at this stage, this might be seen as a step closer to adoption of inflation targeting, even though there were neither tools for realizing such values nor any improvement in the current economic and financial situation. This member expressed the view that in the current situation it would be appropriate to explain clearly that aiming at a positive inflation rate target only through monetary policy would be unlikely to lead to sustainable price stability and sound development of the economy. This view could be explained in terms of the relationship between monetary policy and the outlook for the economy and prices in, for example, the Outlook Report. A different member shared this view, and commented that whether there was a channel through which an announcement of a high inflation rate target by the Bank could increase inflationary expectations, leading to a decline in the real interest rate, depended on what kind of policy tools would be available for the Bank to achieve the target.

In response to these views, one member said that the current commitment in terms of policy duration could be interpreted as adoption by the Bank of inflation targeting in a broad sense. The member continued that the Bank could enhance its accountability and transparency by making a stronger commitment, that is, clearly indicating the target for the inflation rate and the time frame for achieving the target. In addition, setting a ceiling for the inflation rate would be effective in preventing extremely high levels of inflation in the future and it would also serve to anchor the expected inflation rate.

A different member expressed the view that it would be worthwhile to set a target for the inflation rate, if the transmission mechanism for achieving a target inflation rate could be explained properly based on theory, although there was uncertainty as to how the mechanism would operate and there were structural constraints that would make the target inflation rate difficult to achieve.

V. Remarks by Government Representatives

The representative from the Cabinet Office made the following remarks.

(1) Economic activity remained flat and seemed to be in a temporary lull. It was likely that the GDP growth rate for fiscal 2002 would be higher than the Government's forecast, but it was necessary to monitor the economic situation closely because there was significant uncertainty about the outlook. The driving force of the economy was gradually shifting from the household sector to the corporate sector, as evident from the fact that recent indicators of private consumption were weak while business fixed investment marked a slight increase for the third consecutive quarter.

(2) On the policy front, it was important that the Government implement the budget steadily. Regarding structural reforms, the Government would establish special zones for structural reform in April. Further, the Government hoped that the advanced implementation of tax cuts aimed at revitalizing the economy would be effective, although the size of the cuts was small. The Government considered that whether the ratio of the amount outstanding of NPLs relative to total loans could be reduced to 4 percent from the current 8 percent in two years would depend on the role the Industrial Revitalization Corporation of Japan, which was soon going to start operation, would play. As for fiscal policy, there were discussions about drawing up a supplementary budget for fiscal 2003, but the basic policy stance of the Koizumi Cabinet was not to use fiscal policy to fine-tune the economy.

(3) The Government and the Financial Services Agency were responsible for promoting the disposal of NPLs, and to date the moves to reform Japan's financial system had progressed very steadily and in a practical manner. Discussions continued on what the new framework for injection of public funds should be, and the Government would also like to receive comments on the matter from the Bank.

(4) Regarding the issue of enhancing the transparency of the conduct of monetary policy, while the Government would like the Bank to share the same policy goal, the Bank should discuss independently policy measures to achieve the goal. Consistency between a policy goal and policy measures was important in maintaining public confidence in an organization, but at the same time there was not always a strict correspondence between the two.

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

(1) The fiscal year-end had passed without any disruption in the economy despite the military action against Iraq. However, the economic situation remained severe as uncertainty about the outlook persisted. To achieve sustainable economic growth led by private demand, the Government would steadily implement the supplementary budget for fiscal 2002 and the budget for fiscal 2003, and accelerate structural reforms of government expenditure, the tax system, the financial system, and the regulatory system. The Government would like to ask the Bank to continue taking every necessary step, including the provision of ample liquidity in accordance with the contingency clause of the guideline for money market operations, so that emergency situations did not materialize in the market.

(2) The Policy Board decided at the ad hoc Monetary Policy Meeting to further examine the basic framework for the conduct of monetary policy. The Government considered it was appropriate to examine the issue given that prices continued to fall, and hoped that this examination would bear fruit in the very near future.

(3) The Bank had been providing ample liquidity to financial institutions under the quantitative monetary easing framework since March 2001, but this had not stimulated the flow of funds in the economy. The Government hoped that the Bank would devise other measures for more effective liquidity provision, both in terms of quality and quantity, through examination of issues raised at the previous meeting, so that funds would flow smoothly into households and firms and throughout the economy. Overcoming deflation continued to be the most important task for Japan's economic policy. The Government would therefore like the Bank to consider effective monetary easing measures and implement them.

(4) As in the previous meeting, the representative stated his personal view as follows: the Bank's outright purchases of JGBs should be increased to, for example, 2 trillion yen per month from the current 1.2 trillion yen per month, to promote rebalancing of financial institutions' portfolios; and the current ceiling on the Bank's outright purchases of JGBs of the outstanding amount of banknotes should therefore be removed for a set period of time and should be reviewed again after the effects of the above measures materialized.

(5) The Government welcomed the Bank's proposal for measures to foster the ABS market. The Government would like to ask the Bank to implement them swiftly in view of the severe situation in financial markets, as the Bank had the flexibility to take prompt action.

VI. Votes

Based on the above discussions, the majority of members agreed that it was appropriate to maintain the current stance in the guideline for money market operations, and continue to provide ample liquidity in accordance with the contingency clause of the guideline.

One member, however, said that the member would like to propose that the Bank should raise the operating target, the outstanding balance of current accounts at the Bank, to around 25 to 30 trillion yen for the following reasons. First, it was natural and would also contribute to enhancing the credibility of the Bank to clearly indicate the Bank's strong determination to continue quantitative easing by raising the target, even if this was a temporary measure. This was because the outstanding balance had continuously exceeded the ceiling of the current target range since the beginning of March 2003 and significant uncertainty about the economic outlook due to the fall in bank stocks was likely to persist. And second, it was not appropriate to rely excessively on the contingency clause.

With regard to the scheme to promote smooth corporate financing by nurturing the market for ABSs including ABCP, members generally agreed that it should be examined by seeking comments of market participants on the staff proposal.

As a result, the following proposals were submitted.

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 25 to 30 trillion yen.

The proposal was defeated with one vote in favor, eight against.

To reflect the majority view, the chairman formulated the following two proposals.

The Chairman's Policy Proposal on the Guideline for Market Operations:

The guideline for money market operations in 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 17 to 22 trillion yen.

For the time being, given that significant uncertainty including geopolitical risks is likely to persist, the Bank will provide more liquidity irrespective of the above target when necessary to secure financial market stability.

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

Vote against the proposal: Mr. T. Fukuma.

Mr. T. Fukuma dissented for the same reasons that formed the basis for submitting his proposal.

The Chairman's Policy Proposal on the Examination of Possible Purchase of ABSs:

1. In view of the need to strengthen the transmission mechanism of monetary easing, the Bank will examine the possible purchase in money market operations of ABSs, fulfilling the following criteria and having a certain credit quality, as a specific measure for promoting smooth corporate financing through the development of the ABS market.
   - (a) ABSs will be backed mainly by pools of assets related to small and medium-sized firms classified as "normal" through banks' self-assessment process or with equivalent credit standings, and such pools of assets will comprise receivables purchased from and loans to small and medium-sized firms.
   - (b) The overall risk of pooled assets will be restructured into multiple layers representing different degrees of risk.
2. Purchase of ABSs by the Bank will be a temporary measure, given that the financial intermediary function of banks is weak and the ABS market is still in its infancy.
3. The Bank will seek market participants' views when developing the specific design of the purchasing scheme.

4. The Governor will decide on the content of the proposal on the examination of possible purchase when seeking views as prescribed in item 3 above.
5. The specific design of the scheme for the Bank's purchase of ABSs will be discussed and decided at a Monetary Policy Meeting.
6. A public statement concerning the above proposal will be decided separately.

Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Mr. K. Ueda, Mr. T. Taya, Mr. S. Nakahara, Mr. H. Haru, and Mr. T. Fukuma.

Vote against the proposal: Ms. M. Suda.

Ms. M. Suda dissented from the above proposal for the following reasons, although she fully understood the importance of developing the ABS market. First, the Policy Board should have discussed and reached a consensus on what basic criteria the Bank should employ in its purchases of ABSs, such as the degree of credit risk of ABSs eligible for purchase and the amount of the Bank's capital to be allocated for purchases of ABSs, but the criteria were not clear yet. Second, it was inappropriate for the Bank to announce at this point that it was ready to purchase not only senior securities but also mezzanine securities with higher risk, considering the basic features of and constraints on the Bank's capital and the current assessment of the environment surrounding firms' financing conditions. And third, in order to promote the development of the ABS market, the Bank should encourage financial institutions to first develop a scheme of individual loans that could be transferred and could be used to back ABSs at a later stage, and the Bank should therefore take a broader approach, such as making use of on-site examinations, instead of simply purchasing ABSs with a certain level of risk.

VII. Discussion on the Public Statement

Members discussed the draft of the public statement prepared by the staff regarding the decision of the Board on the examination of possible purchase of ABSs and put it to the vote. By majority vote, the Board decided to publish "Examination of Possible Purchase of Asset-Backed Securities" immediately after the meeting (see Attachment 2).

Votes for the proposal: Mr. T. Fukui, Mr. T. Muto, Mr. K. Iwata, Mr. K. Ueda, Mr. T. Taya, Mr. S. Nakahara, Mr. H. Haru, and Mr. T. Fukuma.

Vote against the proposal: Ms. M. Suda.

VIII. Discussion on the Bank's View of Recent Economic and Financial Developments

The Policy Board discussed "The Bank's View" of recent economic and financial developments, and put it to the vote. By unanimous vote, the Board decided to publish "The Bank's View" on April 9, 2003 in the Monthly Report of Recent Economic and Financial Developments (consisting of "The Bank's View" and "The Background").[9]

9 The original full text, in Japanese, of the Monthly Report of Recent Economic and Financial Developments was published on April 9, 2003 together with the English version of "The Bank's View." The English version of "The Background" was published on April 10, 2003.

IX. Approval of the Minutes of the Monetary Policy Meeting

The Policy Board approved unanimously the minutes of the Monetary Policy Meeting of March 4 and 5, 2003 for release on April 11, 2003.

Attachment 1

For immediate release

April 8, 2003
Bank of Japan

At the Monetary Policy Meeting held today, the Bank of Japan decided, by 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 17 to 22 trillion yen.

For the time being, given that significant uncertainty including geopolitical risks is likely to persist, the Bank will provide more liquidity irrespective of the above target when necessary to secure financial market stability.

Attachment 2

For immediate release

April 8, 2003
Bank of Japan

Examination of Possible Purchase of Asset-Backed Securities

1. Ample liquidity provision by the Bank of Japan has made a significant contribution to securing financial market stability and upholding the economy and prices. For the ample liquidity provision to effectively lead to economic expansion, however, it is deemed necessary to strengthen the transmission mechanism of monetary easing.
2. The Bank decided the following at today's Monetary Policy Meeting (MPM) of the Policy Board.
   - a) As a temporary measure, the Bank will examine the possible purchase of asset-backed securities (ABSs), including asset-backed commercial papers, mainly backed by those assets related to small and medium-sized enterprises, for money market operations.
   - b) The Bank will seek market participants' views when developing the specific design of a purchasing scheme.

c) The specific design of the scheme will be discussed and decided at the MPM.

3. Against the background of banks' weak financial intermediary function, today's decision has the objective to strengthen the effects of monetary easing by nurturing the development of the ABS market, thereby promoting smooth corporate financing. In this respect, it is expected that ABSs will play an important role by diversifying and transferring credit risks.
4. Although private debt including ABSs has already been accepted as eligible collateral for money market operations and purchased under repurchase agreements by the Bank, outright purchase of private debt is an unprecedented measure for a central bank. The Bank will determine the specific design of the purchasing scheme considering the following: to what extent the purchase will strengthen the transmission mechanism; whether the purchase will not distort market mechanisms; and how to maintain financial soundness of the Bank.
5. The Bank will continue to review the conduct of monetary policy and take necessary measures in order to strengthen the transmission mechanism of monetary easing and to enhance the transparency of monetary policy.