

Bank of Japan's January Report of Recent Economic and Financial Developments¹

Bank of Japan, Communication, 22 January 2001.

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The Bank's View²

Japan's economy continues to recover gradually, but the pace is slowing due to decelerating export growth.

With regard to final demand, business fixed investment is on an increasing trend. The recovery in private consumption continues to be weak as a whole through lack of notable improvements in employment and income conditions, but there are somewhat positive signs in some indicators. As for public investment, the pace of decline is slowing. Meanwhile, net exports (real exports minus real imports) are starting to decrease reflecting a slowdown in overseas economies such as the U.S. and East Asia. Housing investment is declining gradually.

Reflecting such developments in final demand, industrial production remains on a rising trend, but the pace is slowing considerably. Inventories of some materials and electronics parts, of which demand from overseas is declining significantly, become somewhat excessive, but inventories as a whole still remain at a low level. Meanwhile, corporate profits continue to improve. Income conditions of households still remain severe but are not deteriorating as employment conditions are on an improving trend and wages are slightly above the previous year's level.

As for the outlook, public investment is expected to start increasing with the implementation of the new economic stimulus package by the government. In the corporate sector, firms still strongly feel that they have excess capacity and that they should reduce their debts to restore financial soundness. However, it is very likely that fixed investment in high-growth sectors, including those related to information technology services, will increase as corporate profits continue to recover. Moreover, the improvement in corporate profits will increase household income and this in turn is expected to boost private consumption. However, the pace of recovery in household income will be modest for the time being, since firms' perceptions of excess employment still persist, and thus significant changes have not been observed in their efforts to reduce personnel expenses.

Reflecting the overseas slowing economies, a temporary decline in exports seems to be inevitable. Imports are projected to continue increasing, particularly those of consumer goods, and capital goods and parts. Hence, net exports are expected to decline. Mainly due to these developments in exports, industrial production is expected to slow down and remain at around the current level for a while.

Overall, it is likely that the economy will continue a gradual upward trend led mainly by business fixed investment. In addition, the favorable financial environment created partly by the Bank's continuation of easy monetary stance and the government's new economic stimulus package are expected to underpin the economy. However, risks of downward pressures on the economy induced by the slowdown in overseas economies as well as developments in foreign and domestic capital markets, need more careful monitoring for the time being.

With regard to prices, import prices are rising, mainly reflecting the depreciation of the yen. Domestic wholesale prices are declining somewhat mainly due to the decrease in prices of electrical machinery, although the rise in crude oil prices was passed on to the prices of petroleum products. Consumer prices continue to be somewhat weak owing to the decline in prices of other imported products and their substitutes, despite the increase in prices of petroleum products. Corporate service prices are still falling slowly.

As for the conditions surrounding price developments, the recent yen depreciation is exerting upward pressures on prices. Moreover, the balance between supply and demand in the domestic market is

¹ This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on January 19, 2001.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on January 19 as the basis of monetary policy decisions.

projected to be on a gradual improving trend, while an economic recovery is expected to continue at a moderate pace. Recently, however, the pace of recovery seems to be slowing and crude oil prices, which had been exerting upward pressures on prices, are falling. The declining trend of machinery prices due to technological innovations and the decrease in prices of consumer goods arising from the streamlining of distribution channels will continue to exert downward pressures on prices. Overall, prices are expected to be somewhat weak for the time being.

In the financial market, the overnight call rate is generally moving around 0.25 percent.

Interest rates on term instruments have declined after the increase towards late December. The Japan premium remains negligible.

Yields on long-term government bonds have been around 1.5-1.7 percent since the end of November and are recently moving in the range of 1.5-1.55 percent. The yield spreads between private bonds (bank debentures and corporate bonds) and government bonds are mostly unchanged or expanding somewhat.

Stock prices continue to be weak and are moving around the lowest level recorded since the beginning of 2000, while having recovered somewhat recently.

In the foreign exchange market, the yen has been depreciating sharply since late December and is currently being traded in the range of 117-120 yen to the U.S. dollar.

With regard to corporate finance, private banks continue to be more active in extending loans, mainly to blue-chip companies, while carefully evaluating the credit risks involved. There seem to be no significant changes in the fund-raising conditions of firms in the markets for such instruments as corporate bonds and CP.

On the other hand, the improvement in economic activities has not stimulated corporate demand for external funds, since firms' cash flow is at a high level in parallel with the recovery in profits. Moreover, firms continue to reduce their debts as part of their balance-sheet restructuring measures. As a result, credit demand in the private sector has continued to be basically stagnant.

In view of this, the underlying tone of private banks' lending remains sluggish, although the expansion in the year-on-year decline is ceasing. Meanwhile, the amount outstanding of corporate bonds issued is slightly above the previous year's level. The amount outstanding of CP issued was at a high level as the year-end approached.

Money stock (M_2 + CDs) continues to grow at around 2 percent on a year-on-year basis.

As for funding costs for firms, short-term funding rates basically remain flat but long-term funding rates seem to be declining reflecting the developments in market interest rates.

In this financial environment, the lending attitude of financial institutions and corporate financing conditions remain easy. However, the effects of the decline in stock prices on the fund-raising conditions of firms need to be carefully monitored.