

Bank of Japan's February report of recent economic and financial developments¹

Bank of Japan, 13 February 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 due to lack of notable improvements in employment and income conditions, but there are somewhat positive signs in some indicators. Housing investment is virtually unchanged. 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.

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, for which demand from overseas is declining significantly, have 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.

As for the outlook, public investment is expected to start increasing with the implementation of the government's new economic stimulus package. 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 no significant change has been observed in their efforts to reduce personnel expenses.

It seems to be inevitable that exports will decline for some time reflecting the slowing of economies overseas. 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 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 its easy monetary stance, and the government's new economic stimulus package are expected to underpin the economy. However, attention should be paid to growing risks of downward pressures on the economy induced by a possible further slowdown in overseas economies as well as by developments in foreign and domestic capital markets.

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. 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.

¹ This report was written based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on February 9, 2001.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on February 9 as the basis for monetary policy decisions.

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 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. In addition to the declining trend of machinery prices due to technological innovations, the decrease in prices of consumer goods arising from the streamlining of distribution channels, and the reduction in communications fees aided by deregulation 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 been declining somewhat. The Japan premium remains negligible.

Yields on long-term government bonds have declined to around 1.4-1.45 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.

In the foreign exchange market, the sharp depreciation of the yen since late December has come to a pause. The yen is currently being traded in the range of 114-117 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, lending by private banks remains sluggish, declining at around 2 percent year-on-year. Meanwhile, the amount outstanding of corporate bonds issued is slightly above the previous year's level. The amount outstanding of CP issued continues to be at a high level.

Recently, the growth rate of money stock ($M_2 + \text{CDs}$) is slightly increasing due to the inflow from postal savings.

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.