

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

Bank of Japan, May 21, 2001.

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The Bank's view²

Adjustments in economic activities have been under way, as production is declining reflecting a fall in exports.

With regard to final demand, the recovery in private consumption continues to be weak as a whole, but there are somewhat positive signs in some indicators. Housing investment is declining slightly. Public investment is increasing. On the other hand, net exports (real exports minus real imports) continue to decrease reflecting a slowdown in overseas economies such as those of the U.S. and East Asia. Business fixed investment seems to be leveling off while the exporting conditions continue to deteriorate.

Industrial production is declining sharply, reflecting such developments in final demand and as excessive inventories of electronic parts and some materials are building up. The environment surrounding corporate profits is becoming more severe in line with the decline in exports and production, and business sentiment of firms is worsening particularly in manufacturing. Income conditions of households have not yet deteriorated, but the decline in production is starting to affect the household sector mainly through the decrease in hours worked.

As for the outlook, public investment is expected to continue increasing for the time being. Net exports, however, are likely to continue decreasing for a while, reflecting the ongoing adjustments in overseas economies. Business fixed investment is projected to peak out and then to start a downturn, as the effects from the implementation of a backlog of orders sustaining investment dissipates. In addition, inventory adjustments in goods such as electronic parts and materials will continue for the time being. Industrial production, therefore, is expected to follow a declining trend. In these circumstances, corporate profits are likely to start decreasing and thus household income is expected to weaken gradually.

Overall, the adjustments are likely to continue for some time, mainly in production. Meanwhile, it is generally thought that overseas economies, particularly the U.S., will follow a gradual recovery trend from the latter half of 2001. In this case, exports, helped also by the depreciation of the yen, are expected to underpin the economy once again. However, attention should still be paid to the possibility of a prolonged deceleration of overseas economies and the risk of a negative impact on the economy induced by developments in foreign and domestic capital markets via corporate and household confidence.

With regard to prices, import prices are rising, mainly reflecting the depreciation of the yen. Domestic wholesale prices are declining mainly due to the decrease in prices of electrical machinery. Consumer prices continue to be somewhat weak owing to the decline in prices of imported products and their substitutes. The rate of decrease in corporate service prices is accelerating somewhat owing to the reduction in communications charges.

As for the conditions surrounding price developments, the prior yen depreciation is exerting upward pressure on prices. However, with the ongoing adjustments, the balance between supply and demand in the domestic market is likely to exert downward pressure on prices. In addition, the declining trend of machinery prices caused by technological innovations, the decrease in prices of consumer goods arising from the streamlining of distribution channels, and the reduction in communications charges aided by deregulation will continue to restrain price developments. Overall, prices are expected to be weak for the time being. Moreover, given the high degree of uncertainty regarding future economic

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on May 17 and 18, 2001.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on May 17 and 18 as the basis for monetary policy decisions.

developments, the possibility that weak demand will intensify downward pressure on prices warrants careful monitoring.

In the financial market, the overnight call rate is currently moving at about 0.01 percent, reflecting the guideline for money market operations to maintain the current-account balance at the Bank of Japan at around 5 trillion yen.

Interest rates on term instruments are declining further. The Japan premium remains negligible.

Yields on long-term government bonds recently decreased to around 1.3 percent. The yield spreads between private bonds (bank debentures and corporate bonds) and government bonds are mostly unchanged or contracting somewhat.

Stock prices rose until early May reflecting the recovery in U.S. stocks, but are decreasing slightly thereafter.

In the foreign exchange market, the yen has appreciated slightly and is currently being traded in the range of 122-124 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 firms' perception on the lending attitude of financial institutions. The fund-raising conditions of firms in the markets for such instruments as corporate bonds and CP are improving further owing to the decline in market interest rates and the more active stance of investors to take credit risks.

On the other hand, credit demand of private firms continues to lack momentum as the level of corporate expenditures such as business fixed investment remains below firms' cash flow. 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. The amount outstanding of corporate bonds issued continues to be above the previous year's level but the growth rate is slowing. Meanwhile, the amount outstanding of CP issued is well above that of the previous year marking the highest level to date.

The year-to-year growth rate of money stock (M_2 + CDs) is around 2.5 percent.

Funding costs for firms are declining reflecting developments in market interest rates.

In this financial environment, the lending attitude of financial institutions and corporate financing conditions remain easy. For the time being, attention should be paid to the effects of the additional monetary easing measures taken by the Bank, while careful monitoring is required for the effects of stock price developments and corporate profit conditions on the behavior of financial institutions and the fund-raising conditions of firms.