

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

Bank of Japan, 15 August 2001

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The Bank's view²

Adjustments in economic activities are intensifying further, reflecting a substantial decline in exports and production.

With regard to final demand, private consumption remains flat on the whole. Housing investment is declining and public investment is also starting to decrease since the implementation of the supplementary budget for fiscal 2000 has peaked out. Net exports (real exports minus real imports) continue to decline, reflecting not only a slowdown in overseas economies but also sluggish demand for IT-related goods. Business fixed investment is also decreasing while exporting conditions continue to deteriorate.

Industrial production continues to decline sharply, reflecting such developments in final demand and strong excessiveness in inventories of electronic parts and some materials. Corporate profits and business sentiment are also worsening particularly in manufacturing. Affected by such developments, household income seems to be weakening gradually.

As for the outlook, public investment is expected to follow a declining trend. Net exports are likely to continue decreasing for a while amid the deceleration in overseas economies and ongoing inventory adjustments in IT-related goods worldwide. Judged from leading indicators and investment plans of firms, business fixed investment is projected to follow a downward trend. In addition, inventory adjustments in goods such as electronic parts and materials will continue for the time being. Industrial production is, therefore, expected to follow a declining trend.

There still exist such general views that around the end of this year, ongoing inventory adjustments in IT-related goods worldwide are likely to peak out and overseas economies, particularly the United States, will start to recover. Based on these preconditions, exports are expected to pick up sometime in the future and thus underpin industrial production. However, cautious views on global demand in IT-related goods and developments in overseas economies for both their timing and pace of recovery are recently growing. At home, under the prolonged adjustments in economic activities particularly in production, household income, which is the basis of private consumption, is likely to be weakening gradually along with the decline in corporate profits.

Overall, it seems to be inevitable that adjustments in economic activities, starting from the decrease in exports, will continue for the time being. Moreover, the substantial decline in production would cause domestic demand to decrease and in turn generate the risk of adjustments in economic activities to spread even further. Also, attention should be paid to the risk 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 mostly unchanged. Domestic wholesale prices are weak mainly due to the decrease in prices of electrical machinery and materials. Consumer prices continue to be somewhat weak owing to the decline in prices of imported products and their substitutes. Corporate service prices continue to decrease.

As for the conditions surrounding price developments, the past yen depreciation is exerting upward pressure on prices. However, with the ongoing adjustments in economic activities, the balance between supply and demand in the domestic market is likely to exert downward pressure on prices. Furthermore, in addition to the declining trend of machinery prices caused by technological innovations, the decreases in the prices of goods and services reflecting deregulation and the streamlining of distribution channels 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

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on August 13 and 14, 2001.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on August 13 and 14 as the basis for monetary policy decisions.

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

In the financial market, the overnight call rate is basically moving around zero percent under 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 basically level on the whole. The Japan premium remains negligible.

Yields on long-term government bonds rose temporarily to 1.40-1.45 percent, but are recently moving around the range of 1.30-1.35 percent. The yield spreads between private bonds (bank debentures and corporate bonds) and government bonds are contracting somewhat.

Stock prices are declining around the lowest level since the start of the year.

In the foreign exchange market, the yen is currently being traded in the range of 121-124 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. However, there are some signs indicating that the lending attitudes of financial institutions perceived by small firms are becoming slightly more cautious. Meanwhile, the fund-raising conditions of firms in the markets for such instruments as corporate bonds and CP continue to improve owing to a decline in market interest rates and the more active stance of investors to take credit risks.

On the other hand, credit demand in the private sector seems to be declining slightly faster due to a decrease in business fixed investment while firms continue to reduce their debts.

In view of this, private banks' lending remains sluggish. Meanwhile, the growth rate of amount outstanding of corporate bonds issued is on the gradually rising trend, reflecting the favorable environment for issuing corporate bonds. The amount outstanding of CP issued is well above that of the previous year and marking the highest level to date.

The growth rate of money stock ($M_2 + \text{CDs}$) in July was slightly higher than that of the previous month due mainly to the inflow from postal savings.

Funding costs for firms continue to be at extremely low levels.

In this financial environment, the lending attitudes of financial institutions and corporate financing conditions remain easy as a whole. For the time being, attention should be paid to the effects of the 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.