

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

Bank of Japan, 20 September 2001

* * *

The Bank's View²

Adjustments in economic activity are becoming more severe, as the substantial decline in production, starting from a fall in exports, is beginning to have a negative influence on employment and income conditions.

With regard to final demand, 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 noticeably while exporting conditions continue to deteriorate. Housing investment remains sluggish and public investment is declining. Meanwhile, private consumption remains flat on the whole, although there are some weak indicators.

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

Turning to 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. Based on the developments in leading indicators and judged from the successive downward revisions of firms' investment plans in the information and communications sector, business fixed investment is also expected to follow a downward trend. Private consumption is likely to become weak gradually while employment and income conditions continue to deteriorate. In addition to such developments in final demand, 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.

As for IT-related goods, although the sluggish final demand of these goods worldwide has been preventing the progress in inventory adjustments, the view that the adjustments are likely to finish by around next spring is prevailing. Therefore, the decline production in this sector is expected to cease some time in the future. However, uncertainty regarding the outlook for the recovery of overseas economies, particularly for the U.S., is growing further while the global economy continues to decelerate concurrently. At home, while the income-generating mechanism from corporate profits to employment and wages is starting to work adversely, government spending is projected to follow a downward trend. Under these circumstances, it may take some time for overall production activity to stop declining.

Overall, adjustments in economic activity, starting from the decline in exports, are expected to have a negative influence on domestic demand gradually and this in turn will possibly prolong the ongoing adjustments. Moreover, while the economy continues to be in a fragile state, attention should be paid to the growing risks 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 declining mainly reflecting the softening of international commodity prices. Domestic wholesale prices are also declining somewhat faster because the effects from the past high crude oil prices and the prior depreciation of the yen have abated, while prices of electrical machinery and materials continue to decrease. Consumer prices are weakening owing mainly to the decline in prices of imported products and their substitutes. Corporate service prices continue to decrease.

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on September 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 September 18 as the basis for monetary policy decisions.

As for the conditions surrounding price developments, with the ongoing adjustments in economic activity, 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 follow a gradual declining trend for the time being. Moreover, given the high degree of uncertainty regarding 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 declined further and is moving around zero percent as the current-account balances at the Bank of Japan were increased to around 6 trillion yen due to the changes in the guideline for money market operations decided at the Monetary Policy Meeting held on August 14.

Interest rates on term instruments are declining further owing to the monetary easing by the Bank. The Japan premium remains negligible.

Yields on long-term government bonds are recently moving around 1.35 percent. The yield spreads between private bonds (bank debentures and corporate bonds) and government bonds are mostly unchanged.

Stock prices are plunging reflecting the drop in U.S. stocks.

In the foreign exchange market, the yen is currently being traded in the range of 116-119 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, 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 be favorable 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 is declining faster mainly due to a decrease in business fixed investment while firms continue to reduce their debts.

In view of this, the year-on-year rate of decline in private banks' lending is expanding slightly. The growth rate of amount outstanding of corporate bonds issued is about 2 percent on a year-on-year basis. Meanwhile, the amount outstanding of CP issued continues to be at a high level, significantly exceeding that of the previous year due to the favorable environment for issuing CP.

The growth rate of money stock ($M_2 + \text{CDs}$) in August 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.

With respect to the recent financial environment, the effects of monetary easing are permeating through the economy. This can be observed such as in the additional easing in the money market conditions, further decline in short-term interest rates, higher growth in monetary indicators, and the improvement in the fund-raising conditions of firms through the markets. However, against the background of deteriorating corporate earnings and the more cautious lending attitudes of financial institutions, fund-raising conditions of small firms seem to be becoming more severe. Hence, the developments in the behavior of financial institutions and corporate financing need careful monitoring.

In addition, it is necessary to carefully monitor the effects of the terrorist attacks in the U.S. on global financial markets and economic activity.