Bank of Japan's January report of recent economic and financial developments[1]

Bank of Japan, 17 January 2002

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The Bank's View[2]

Japan's economy is deteriorating broadly, as private consumption is weakening in addition to a decline in exports and business fixed investment.

With regard to final demand, net exports (real exports minus real imports) keep on a declining trend and business fixed investment is also decreasing. Housing investment remains sluggish and public investment is on a downward trend. Moreover, private consumption is weakening.

As for inventories, although the adjustment is progressing in many industries including electronic parts, a strong excessiveness in inventories still exists, mainly in materials. Under this situation, industrial production continues to decline considerably. Corporate profits are falling and business sentiment keeps on worsening. The weakness in household income is becoming noticeable amid the decrease in the hours worked and the rise in unemployment, and consumers are becoming cautious.

Turning to the outlook, as for exporting conditions, even though final demand for IT-related goods still remains stagnant, the view that inventory adjustments in IT-related goods worldwide will be mostly completed around this spring has become dominant. Furthermore, the yen's depreciation is expected to underpin exports. Still, the world economy continues to decelerate and there is considerable uncertainty about future economic developments especially in the U.S. Therefore, such concern still exists that downward pressure may be exerted on Japan's exports and production once again depending on the developments in overseas economies such as the U.S.

Meanwhile, with respect to domestic demand, business fixed investment is expected to follow a downtrend amid the fall in corporate profits. Private consumption will also continue to be weak with deteriorating employment and income conditions and the more cautious consumer sentiment. Government spending is basically projected to follow a downward trend while domestic private demand generally weakens on top of the strong uncertainty about exporting conditions. Consequently, it may take quite a while for economic activity as a whole to stop declining, even though the decrease in industrial production may moderate somewhat in line with the progress in inventory adjustments such as of IT-related goods.

Overall, Japan's economy will inevitably continue to deteriorate for a while. In this situation, continuous attention should be paid to the risk of a negative impact on the economy induced by developments in foreign and domestic financial markets.

With regard to prices, import prices are starting to rise with the decline in international commodity prices coming to an end and the yen weakening. Domestic wholesale prices continue to decline as a whole mainly in machinery and chemical products, although the decrease in the prices such as of electronic parts seems to have ceased. Consumer prices are weakening reflecting the decline in prices of imported products and their substitutes. Corporate service prices continue to decrease.

As for the conditions surrounding price developments, the effects of the past decline in crude oil prices are likely to continue for a time. On the other hand, the recent yen's depreciation is regarded as a factor to support prices in the period ahead. However, as the economy continues to deteriorate, the balance between supply and demand in the domestic market will increasingly 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

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[1] This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on January 15 and 16, 2002.

[2] The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on January 15 and 16 as the basis for monetary policy decisions.

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 continues to move around zero percent as the Bank of Japan provided further ample liquidity to the money market by aiming at maintaining the outstanding balance of the current accounts at the Bank at around 10 to 15 trillion yen due to the changes in the guideline for money market operations decided at the Monetary Policy Meeting held on December 19.

Interest rates on term instruments are declining on the whole reflecting additional monetary easing measures. The Japan premium remains negligible.

Yields on long-term government bonds rose slightly and are mainly moving around 1.40-1.45 percent recently. As for the yield spreads between private bonds (bank debentures and corporate bonds) and government bonds, while spreads between bonds with relatively high credit ratings and government bonds remain mostly unchanged, those between bonds with low credit ratings and government bonds tend to expand.

Stock prices rebounded somewhat towards the start of the year, but are weakening recently.

In the foreign exchange market, the yen depreciated further towards the start of the year, and is currently being traded above 130 yen to the U.S. dollar.

With regard to corporate finance, private banks appear to be more cautious in extending loans to firms with high credit risks while they continue to be more active in extending loans to blue-chip companies. The lending attitudes of financial institutions as perceived by firms are gradually becoming more severe. In corporate bonds and CP markets, the fund-raising conditions continue to be generally favorable particularly for firms with high credit ratings as seen in a slight decline in CP issuance rates, but the issuing environment for those with low credit ratings is deteriorating on the whole.

Credit demand in the private sector continues to follow a downtrend mainly because firms are decreasing their business fixed investment while continuously reducing their debts.

Amid these developments, private banks' lending continues to decline at about 2 percent on a year-on-year basis. As for the amount outstanding of corporate bonds issued, the year-on-year growth rate has been slowing due to a decrease in the issuance of corporate bonds with low credit ratings. The year-on-year growth rate of the amount outstanding of CP issued is declining recently, although the amount is still well above the previous year's level.

The year-on-year growth rate of money stock (M_2 + CDs) continues to be around three to four percent.

Funding costs for firms continue to be at extremely low levels on the whole, although market funding costs for some firms and the long-term prime lending rate are rising somewhat.

Overall, the recent financial environment remains extremely easy on the whole in terms of money market conditions and interest rate levels: additional monetary easing measures by the Bank have increased liquidity in the money market and prompted declines in interest rates on term instruments and the issuance rate of CP with high credit ratings. However, the fund-raising conditions of firms with high credit risks, especially of small firms, are becoming severe as private banks and investors are becoming more cautious in taking credit risks against the background of a growing number of corporate bankruptcies. Hence, the developments in the behavior of financial institutions and corporate financing need closer monitoring.