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

Bank of Japan, 22 March 2002

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The Bank's View[2]

Japan's economy still continues to deteriorate as a whole, although the downward pressure from exports and inventories is gradually abating.

With regard to final demand, the decline in net exports (real exports minus real imports) has almost ceased amid the improvement in exporting conditions. Meanwhile, business fixed investment continues to decrease and private consumption remains weak. Moreover, housing investment remains sluggish and public investment is also declining.

To be sure, final demand overall is still weak, but exports—which have a relatively large impact on production—have recently stopped declining. Also, inventory adjustment is progressing further in many industries including electronic parts due to the continued production cutbacks to date. Reflecting these developments, the decline in industrial production is moderating further. However, firms maintain their stance on reducing personnel expenses under strong excessiveness in employment. Under this situation, the severity of employment and income conditions of households is rather intensifying, with unemployment being on a rising trend and the rate of decline in wages expanding.

Turning to the outlook, as for exporting conditions, the synchronized inventory adjustment in IT-related goods worldwide is nearing an end. Under this condition, the East Asian economies appear to have hit bottom. As for the U.S., the possibility is increasing that the economy will recover since household spending remains solid and inventory adjustment has almost finished, although there still remain uncertain factors. Furthermore, the yen is at low levels compared to last autumn. Under these circumstances, exports are expected to turn up toward the middle of this year. Still, the pace of recovery in exports will be modest, while the anticipated expansion in overseas economies is only gradual and final demand for IT-related goods worldwide remains stagnant for the time being.

Meanwhile, with respect to domestic demand, business fixed investment is expected to follow a downtrend reflecting the fall in corporate profits. Private consumption is also likely to remain lackluster mainly due to worsening employment and income conditions. While domestic private demand generally weakens as mentioned above, government spending is basically projected to follow a downward trend. Consequently, it may take quite a while for economic activity as a whole to stop declining, even though the decrease in industrial production may come to an end against the background of the improvement in exporting conditions and completion of inventory adjustment.

Overall, the economic deterioration in Japan is projected to moderate steadily, as production stops declining due mainly to the recovery in exports. Still, while the economy continues to be in a fragile state, continuous attention should be paid to the risk of a negative impact on the economy from developments in foreign and domestic financial markets.

With regard to prices, import prices are increasing reflecting the depreciation of the yen since around the end of last year and the rise in international commodity prices. The decline in domestic wholesale prices is recently contracting somewhat against the background of the increase in import prices and the progress in inventory adjustment. Consumer prices continue to decline with the effects of the fall in crude oil prices in the latter half of last year persisting, while the prices of imported products and their substitutes keep on falling. Corporate service prices continue to decline.

As for the conditions surrounding price developments, the depreciation of the yen from around the end of last year and the rise in international commodity prices are regarded as factors to support prices for the time being. However, since domestic demand is projected to remain weak for a time, the balance between supply and demand is expected to keep exerting downward pressure on prices. Furthermore, factors such as the ongoing technological innovations in machinery, deregulation, and the streamlining

1 This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on March 19 and 20, 2002.

2 The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on March 19 and 20 as the basis for monetary policy decisions.

of distribution channels will restrain prices. In addition, the expansion in the rate of decline in wages may also work as a factor to push prices downward, mainly in services prices which are apt to be influenced by this factor. 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 continuously warrants careful monitoring.

In the financial market, the overnight call rate continues to move around zero percent as the Bank of Japan provided 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.

Interest rates on term instruments rose somewhat temporarily generated by the activation of fund-raising beyond the fiscal year-end since mid-February, but continue to be at low levels since this rise was constrained due to additional measures decided at the Monetary Policy Meeting on February 28.

Yields on long-term government bonds are mainly moving in the range of 1.4-1.5 percent recently. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds are expanding slightly.

Stock prices started to turn up due to tighter regulations on short-selling of stocks and the rise in U.S. stocks, and are subsequently increasing as domestic and foreign institutional investors bought back.

In the foreign exchange market, the yen surged temporarily in reaction to the rise in Japanese stock prices but is weakening once again thereafter.

With regard to corporate finance, private banks are becoming 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 becoming more severe. In corporate bonds and CP markets, the fund-raising conditions are generally favorable particularly for firms with high credit ratings, but the issuing environment for those with low credit ratings continues to be severe 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. Meanwhile, the amount outstanding of corporate bonds issued is growing at around 2-3 percent on a year-on-year basis. The year-on-year growth rate of the amount outstanding of CP issued continues to decline, although the amount is still well above the previous year's level.

The year-on-year growth rate of the monetary base has increased further and is recording a substantial increase of somewhat less than 30 percent. The year-on-year growth rate of the money stock (M_2 + CDs) has increased slightly.

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. However, the fund-raising conditions of firms with high credit risks, especially of small firms, are gradually becoming more severe as private banks and investors continue to be more cautious in taking credit risks. Hence, the developments in the behavior of financial institutions and corporate financing continue to require closer monitoring.