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

Bank of Japan, 22 May 2002.

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The Bank's View[2]

The pace of deterioration in Japan's economy has moderated, with production starting to pick up reflecting the increase in exports and progress in inventory adjustment.

With regard to final demand, business fixed investment continues to decrease and private consumption remains weak. Moreover, housing investment remains sluggish and public investment is on a downtrend. Meanwhile, net exports (real exports minus real imports) are increasing due to the recovery in overseas economies.

Industrial production is starting to pick up, reflecting the increase in exports and also the further progress in inventory adjustment as a whole. However, firms are maintaining their stance on reducing personnel expenses given persistently strong excessiveness in employment. Therefore, employment and income conditions of households continue to worsen, reflecting the decrease in the number of employees and the faster pace of decline in wages.

Turning to the outlook, with respect to domestic demand, business fixed investment is expected to follow a downtrend for a while, judged mainly from leading indicators and firms' investment plans. Private consumption is also likely to remain lackluster mainly due to worsening employment and income conditions. In addition, government spending is basically projected to continue a downward trend.

Meanwhile, as for exporting conditions, overseas economies, especially in the U.S. and East Asia, are likely to follow a recovery path. The worldwide inventory adjustment in IT-related goods has come to an end except for some goods such as networking equipment. Moreover, the yen is still lower than where it was last autumn. Under these circumstances, exports are projected to continue a moderate recovery. Industrial production is likely to follow a gradual uptrend supported by the increase in exports and also by the progress in inventory adjustment. This increase in production will help corporate profits to recover, particularly in the manufacturing sector, and is expected to gradually support domestic private demand such as business fixed investment.

Overall, Japan's economy is projected to stop deteriorating as a whole since an increase in exports and production will lead to an improvement in corporate profits and in turn, domestic private demand. However, in addition to the weak employment and income conditions, the pace of increase in exports and production is likely to remain modest on balance. Therefore, it will take a while for the positive effects, stemming from the developments in exports and production, to spread across the nonmanufacturing sector, small firms and households. With regard to the outlook for overseas economies, an essential element for exports, there are various uncertain factors including the U.S. economy, and the developments in crude oil prices and its effects on the global economy. Amid the persisting fragility and uncertainty of the economy, continuous attention should be still kept in mind that unstable movements in the foreign and domestic financial markets, including the foreign exchange market, would easily exert a negative influence on the economy.

On the price front, import prices continue to rise mainly due to higher crude oil prices. Domestic wholesale prices are almost flat recently since the decline in machinery prices and the reduction in electricity charges are offset against the increase in import prices and the effects of the progress in inventory adjustment. However, consumer prices and corporate service prices continue to decline.

As for the conditions surrounding price developments, past depreciation of the yen and the rise in crude oil 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

[1] This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on May 20 and 21, 2002.

[2] The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on May 20 and 21 as the basis for monetary policy decisions.

to keep exerting downward pressure on prices. Furthermore, factors such as the ongoing technological innovations in machinery, deregulation, and the streamlining of distribution channels will restrain prices. In addition, the faster pace of decline in wages may also work as a factor to push prices downward, mainly in services prices which are sensitive to wage developments. Reflecting these factors, domestic wholesale prices, which tend to be greatly affected by the exchange rate and crude oil prices, are likely to be more or less flat for the time being. On the other hand, consumer prices are expected to stay on a gradual declining trend.

As for the financial market, in the short-term money markets, the outstanding balance of the current accounts at the Bank of Japan is recently moving around 15 trillion yen as the Bank continues to provide ample liquidity to the money market.

In these circumstances, the overnight call rate continues to move around zero percent. Moreover, interest rates on term instruments remain steady.

Yields on long-term government bonds are moving in the range of 1.3-1.4 percent recently. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds are contracting slightly. However, spreads between bonds with low credit ratings and government bonds still remain wide.

Stock prices are level on the whole and are basically moving in the range of 11,000-12,000 yen.

In the foreign exchange market, the yen appreciated reflecting the overall downtrend in U.S. dollars due mainly to weak U.S. stock prices.

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 issuing environment for firms with low credit ratings continues to be severe on the whole, but the environment for firms with high credit ratings is improving recently.

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 by about 2-3 percent on a year-on-year basis. The year-on-year growth rate of the amount outstanding of corporate bonds issued is decreasing somewhat. 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 in April increased further due partly to the continued high liquidity demand even after entering the new fiscal year, reflecting a system failure of a major bank group. The year-on-year growth rate of the money stock (M_2 + CDs) remained around 3.5-4.0 percent.

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

Overall, the recent financial environment remains extremely easy on the whole in terms of money market conditions. The deterioration in the financial position of firms is coming to a halt. However, the stance of investors toward firms with high credit risks remains severe and the lending attitudes of private banks are becoming more cautious. Hence, the developments in the behavior of financial institutions and corporate financing continue to require close monitoring.