

Bank of Japan's July report of recent economic and financial developments

Bank of Japan, 17 July 2002.

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The Bank's view

Japan's economy, despite continued weakness in domestic demand, has almost stabilized as a whole with an increasing upward impetus from exports and production, and an improvement in corporate profits and business sentiment.

With regard to final demand, business fixed investment continues to decrease and private consumption, despite some resilience, remains weak as a whole. Moreover, housing investment remains sluggish and public investment is on a downtrend. Meanwhile, net exports (real exports minus real imports) are increasing significantly due to the recovery in overseas economies and also to the effects of restocking abroad, mainly in IT-related goods.

Industrial production is picking up clearly in response to the increase in exports and adequate reduction of excess inventory stocks. Against this background, corporate profits appear to be turning up and business sentiment is improving. In addition, the rebound in production affects employment conditions, albeit marginally, with an increase in overtime hours worked and in new job offers mainly for part-time workers. However, firms are still maintaining their stance on reducing personnel expenses and as a consequence, household income continues to decrease noticeably. Thus, employment and income conditions of households overall remain severe.

Turning to the economic outlook, the upward trend in exports are expected to continue against the background of the gradual recovery in overseas economies, although the pace is likely to slow as the impetus from overseas restocking weakens. Thus, industrial production is expected to follow a gradual uptrend with some fluctuations in its pace.

On the other hand, with respect to domestic demand, public investment is projected to follow a declining trend and private demand is likely to remain weak for the immediate future. Yet, if the increase in exports and production mentioned above continues, the recovery in corporate profits will become distinct, and this will gradually bring a positive impact on domestic private demand. In fact, leading indicators of business fixed investment show some signs of stabilizing.

Overall, it can be envisaged that the stabilization of Japan's economy will become more secured as the increase in exports and production, through the improvement in corporate profits, will underpin domestic private demand. However, considering that forces restraining the economy, such as excessive employment and debt, are still persistently at work, momentum for a self-sustaining recovery will be subdued for some time. Furthermore, uncertainty regarding external conditions, particularly in the IT-related sector, is somewhat rising amid a fall in stock prices in the U.S. and worldwide as well as depreciation of the U.S. dollar. In these circumstances, it should be heeded that further destabilization in the foreign exchange and financial markets at home and abroad would easily exert a negative influence on the economy.

On the price front, import prices are turning down due to the U.S. dollar's depreciation against the yen since this spring. Domestic wholesale prices are leveling off since a decline in machinery prices and a reduction in electricity charges are offset by the effects of the increase in import prices until recently and the completion of inventory adjustment. Meanwhile, consumer prices stay on a gradual downtrend and corporate services prices continue to decline.

As for the conditions surrounding price developments, the balance between supply and demand is expected to still keep exerting downward pressure on prices for a while amid persistently weak domestic demand, although the completion of inventory adjustment will support prices to some degree. Moreover, factors such as the ongoing technological innovations in machinery, deregulation, and the streamlining of distribution channels will continue to restrain prices. With import prices beginning to turn down, the currently unchanged domestic wholesale prices is likely to edge down again as they are sensitive to import prices. Consumer prices are expected to stay on a declining trend for the time being at the current gradual pace. This is because while the slower growth in imports of consumer goods is expected to alleviate the downward pressure on prices to some extent, the faster

pace of decline in wages may possibly reinforce the ongoing decline in prices, especially for services prices.

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, longer-term interest rates remain steady.

Yields on long-term government bonds inched down in response to a fall in stock prices and are mainly moving in the range of 1.2-1.3 percent recently. As for yield spreads between private bonds (bank bonds and corporate bonds) and government bonds, the downtrend from the start of this fiscal year has come to a halt since mid-June.

Stock prices fell through June in line with a decline in U.S. stock prices, but have edged up thereafter and are recently mixed, moving around 10,500 yen.

In the foreign exchange market, the yen continued to appreciate reflecting the overall downtrend in the U.S. dollar, and is currently traded around 115-117 yen to the U.S. dollar.

With regard to corporate finance, private banks are becoming 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 continue to be severe. In the corporate bonds and CP markets, the issuing environment for firms with low credit ratings remains severe, but the environment for firms with high credit ratings is on an improving trend.

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. The year-on-year growth rate of the amount outstanding of CP issued has slowed, although the amount is still above the previous year's level.

The monetary base increased substantially by around 20-30 percent from the previous year's level, although the growth rate slowed slightly. The year-on-year growth rate of the money stock remained around 3.5 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 financing situation 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 behaviour of financial institutions and corporate financing continue to require close monitoring.