

## Bank of Japan's December report of recent economic and financial developments<sup>1</sup>

Bank of Japan, 20 December 2001.

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### The Bank's View<sup>2</sup>

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) continue to decline and business fixed investment is also decreasing. Housing investment remains sluggish and public investment is on a downward trend. Moreover, private consumption is weakening recently.

Industrial production continues to decline considerably, reflecting these developments in final demand and the still strong excessiveness in inventories mainly in materials. 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 consumer confidence is becoming cautious.

Turning to the outlook, as for exporting conditions, inventory adjustments in IT-related goods worldwide are showing steady progress, and this has strengthened the view that adjustments will be mostly completed by around next spring. However, as final demand of IT-related goods still remains stagnant, a distinct recovery in exports of the sector is unlikely for the time being. Moreover, the world economy has decelerated further since the terrorist attacks of September 11, and there is considerable uncertainty about future economic developments especially for 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 downward trend amid the fall in corporate profits. Private consumption will also continue to be weak along 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 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 continue to decline reflecting the softening of international commodity prices. Domestic wholesale prices are declining faster from the effects of the fall in crude oil prices in addition to the continuous decreases in prices of electrical machinery and materials. Consumer prices are weakening owing mainly to the decline in prices of imported products and their substitutes. Corporate service prices continue to decrease.

As for the conditions surrounding price developments, crude oil prices remain weak. Also, as the economy will continue 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 degree of uncertainty regarding future economic developments, the

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<sup>1</sup> This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on December 18 and 19, 2001.

<sup>2</sup> The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on December 18 and 19 as the basis for monetary policy decisions.

possibility that weak demand will further intensify downward pressure on prices warrants careful monitoring.

In the financial market, the overnight call rate is moving around zero percent as the Bank of Japan provided ample liquidity to the money market by aiming at maintaining the current account balances held at the Bank at above 6 trillion yen.

Interest rates on term instruments basically continue to be level. The Japan premium remains negligible.

Yields on long-term government bonds are virtually flat, and are mainly moving around 1.35 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 continue to expand slightly.

Stock prices are weakening recently.

In the foreign exchange market, the yen is currently being traded in the range of 127 -129 yen to the U.S. dollar, moving around the lowest level for this year.

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 becoming more cautious. In corporate bonds and CP markets, the fund-raising conditions continue to be generally favorable particularly for firms with high credit ratings, although the issuing environment for those with low credit ratings is deteriorating.

Credit demand in the private sector is declining faster 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 growth rate of money stock ( $M_2$  + CDs) in November increased slightly from the previous month owing to a rise in demand deposits.

Funding costs for firms continue to be at extremely low levels on the whole, although market funding costs for some firms are rising.

Overall, the recent financial environment remains extremely easy in terms of money market conditions and interest rate levels. 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.