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

Bank of Japan, 23 January 2003.

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The Bank's view[2]

Japan's economy has stabilized as a whole, but there is still substantial uncertainty about the prospects for a recovery.

With regard to final demand, while the decline in business fixed investment has almost come to a halt, private consumption continues to be weak. Moreover, housing investment remains sluggish and public investment is declining. There are still no signs of recovery in domestic demand, and exports continue to be virtually level.

Industrial production is basically level in response to these developments in final demand. As for the employment situation, overtime hours worked and new job offers are on a gradual rising trend. In addition, the number of employees, which covers various types of employees including non-regular employees such as temporary workers, appears to have gradually stopped declining. However, firms are still maintaining their stance on reducing personnel expenses, and household income continues to decrease significantly due to, among other factors, an ongoing decline in wages. Thus, the employment and income situation of households overall remains severe.

Turning to the economic outlook, a widely shared view of the prospect for overseas economies in 2003 is that they will follow a gradual recovery path. However, their recovery is likely to be anemic, at least for the time being, given that economic indicators for the United States and for some other regions are soft on the whole. In this situation, exports and industrial production are expected to be more or less unchanged for the immediate future.

With respect to domestic demand, public investment is projected to follow a declining trend, and private consumption is likely to remain weak for some time due to the severe employment and income situation. Business fixed investment is expected to be supported by the improvement in corporate profits to date, but a noticeable recovery is unlikely for the time being due to, among other factors, substantial uncertainty regarding overseas economies.

Overall, assuming that overseas economies will recover in 2003, albeit at a moderate pace, the increase in exports and production will resume sooner or later, which in turn will gradually make the foundations of Japan's economic recovery firmer. However, the economy is unlikely to show clear signs of recovery for some time, since exports and production are expected to be virtually unchanged for the time being while downward pressures such as excessive labor input and debt persist. Furthermore, the downside risk to the economic outlook for the United States and other overseas economies continues to require attention, given that there are some uncertain factors including geopolitical developments and their economic implications. On the domestic side, stock prices are weak. Hence, careful monitoring is required of progress in the resolution of the nonperforming-loan problem and its effects on stock prices, corporate finance, and the economy.

On the price front, import prices continue to rise reflecting the firmness in oil prices and depreciation of the yen from summer to autumn 2002. The decline in domestic corporate goods prices has become slower due to the rise in import prices and the improved supply-demand balance in materials industries, despite the continued fall of machinery prices. Consumer prices remain on a gradual downtrend and corporate services prices continue to decline.

Looking at the conditions influencing price developments, import prices are likely to be level because the effect of the rise in oil prices will be offset by that of the recent appreciation of the yen. Although

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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 21 and 22, 2003.

2 The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on January 21 and 22, 2003, as the basis for monetary policy decisions.

the low levels of inventories will support prices to some degree, the overall condition of supply and demand is expected to continue exerting downward pressure on prices for a while amid persistently weak domestic demand. Moreover, factors such as the ongoing technological innovations in machinery, deregulation, and the streamlining of distribution channels will continue to exert downward pressure on prices. Under these circumstances, domestic corporate goods prices are expected to be weak for a while. Consumer prices are expected to stay on a declining trend for the time being at the current gradual pace. The increase in imports of consumer goods has come to a halt and this is expected to alleviate the downward pressure on prices to some extent, but the faster pace of decline in wages may reinforce the ongoing decline in prices, especially that in services prices.

As for the financial environment, the outstanding balance of the current accounts at the Bank of Japan is recently moving at around 20 trillion yen, as the Bank provides ample liquidity. Under these circumstances, in the short-term money markets, the overnight call rate continues to hover at very close to zero percent. Moreover, longer-term interest rates continue to be at low levels as a whole.

Yields on long-term government bonds declined further and are recently moving in the range of 0.8-0.9 percent, as the demand of banks and other institutional investors for the bonds has become even stronger. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds remain virtually unchanged.

Stock prices continue to be weak, reflecting the uncertainty about the domestic economic outlook. The Nikkei 225 Stock Average is recently moving at around 8,500 yen.

In the foreign exchange market, the yen has been strengthening somewhat, reflecting the weakening of the U.S. dollar on the whole mainly caused by the strained situation in the Middle East. The yen is currently traded in the range of 117-119 yen to the U.S. dollar.

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, particularly small ones, continue to be severe. In the corporate bond and CP markets, the issuing environment for firms with high credit ratings is accommodative, but the environment for firms with low credit ratings is severe.

Credit demand in the private sector continues to follow a downtrend mainly because business fixed investment remains sluggish while firms are 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 amount outstanding of corporate bonds and CP issued is moving at around the previous year's level.

Meanwhile, according to business surveys, the financial position of firms, particularly that of small firms, remains severe.

The monetary base exhibits a high year-on-year growth rate of around 20 percent. The year-on-year growth rate of the money stock dropped to around 2.0-2.5 percent in December.

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

Against the above background, the financial developments are summarized as follows. Money market conditions as a whole continue to be extremely easy. Long-term interest rates are declining. The money stock and the monetary base maintain high growth rates relative to that of economic activity as a whole. However, stock prices remain unstable. In corporate finance, the fund-raising environment of firms with low credit risks is accommodative on the whole, but with regard to firms with high credit risks, the stance of investors is severe and the lending attitudes of private banks are becoming more cautious. Hence, including the effects arising from government measures to accelerate the disposal of non-performing loans and to revitalize industries and firms, developments in the financial and capital markets, the behavior of financial institutions, and the situation of corporate finance continue to require close monitoring.