

Bank of Japan's March report of recent economic and financial developments¹

Bank of Japan, 6 March 2003.

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The Bank's View²

Economic activity remains flat amid substantial uncertainty about the outlook for the economy.

With regard to final demand, while business fixed investment has been virtually level, private consumption continues to be weak. Moreover, housing investment remains sluggish and public investment is declining. While domestic demand has yet to show signs of recovery, both exports and imports are increasing at a very modest pace with net exports remaining virtually level.

Industrial production continues to be basically level in response to these developments in final demand. As for the employment situation, 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 be declining at a slower pace. However, firms are still maintaining their stance on reducing personnel expenses, and household income continues to decrease significantly due mainly to 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, partly due to the continued firmness in Asian economies, they will follow a gradual recovery path. However, their recovery is likely to be anemic, at least for the time being, given the sluggish improvement in the U.S. economy and further weakness in European economies. In this situation, the increase in exports is expected to remain very modest, and industrial production is likely 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 is unlikely to recover clearly for the time being due mainly to substantial uncertainty regarding overseas economies.

Overall, assuming that overseas economies will recover in 2003, albeit only at a moderate pace, the increase in exports will accelerate and the uptrend in production will resume sooner or later, which in turn will initiate the momentum for a recovery. However, the economy is unlikely to show clear signs of recovery for some time, since production is 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 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 are on a rising trend with some fluctuations, reflecting developments in prices of overseas commodities such as crude oil. Domestic corporate goods prices have been declining gradually on the whole with the continued fall in machinery prices, despite the rise in import prices and the improved supply-demand balance in materials industries. Consumer prices and corporate services prices have also been declining gradually.

Looking at the conditions influencing price developments, import prices are projected to be firm for the time being due mainly to developments in crude oil prices. On the other hand, factors such as the ongoing technological innovations in machinery and the streamlining of distribution channels will continue to push prices downward. Meanwhile, the overall state of supply and demand is expected to

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on March 4 and 5, 2003.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on March 4 and 5, 2003 as the basis for monetary policy decisions.

continue exerting downward pressure on prices, with domestic demand continuing to be weak for a while. However, the low levels of inventories and the improvement in the supply-demand balance in materials industries will support prices in corporate transactions. Against this background, the decline in domestic corporate goods prices is likely to be mitigated in the near term. The pace of year-on-year decline in consumer prices is expected to become somewhat slower, as medical costs are projected to rise from April due to public insurance reforms.

As for the financial environment, the outstanding balance of 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 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 on the whole, and the markets remain steady to date as the fiscal year-end approaches.

Yields on long-term government bonds declined again to the range of 0.7-0.8 percent after moving in the range of 0.8-0.9 percent until mid-February. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds are contracting slightly.

Stock prices are weakening slightly reflecting the heightened uncertainty about geopolitical developments and uncertainty regarding the domestic economic outlook. The Nikkei 225 Stock Average is recently moving at the 8,000-8,500 yen level.

In the foreign exchange market, the yen is currently traded in the range of 117-119 yen to the U.S. dollar, as the dollar continues to be weak due mainly to greater tension in the Middle East.

With regard to corporate finance, private banks remain 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, are 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 and 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, financial positions of firms, particularly those of small firms, remain severe.

The year-on-year growth rate of the monetary base is around 10-15 percent. The year-on-year growth rate of the money stock is around 2.0 percent.

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 continue to be extremely easy. Long-term interest rates are declining slightly. The money stock and the monetary base maintain high growth rates relative to that of economic activity as a whole. However, stock prices remain weak. 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 continue to be cautious. Developments in the financial and capital markets, the behavior of financial institutions, and the situation of corporate finance continue to require close monitoring.