

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

Bank of Japan, 9 April 2003

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The Bank's View²

Economic activity remains flat as a whole, despite some signs of improvement, with greater uncertainty about the economic outlook partly due to Iraq-related developments.

With regard to final demand, although business fixed investment is starting to recover, private consumption continues to be weak. Moreover, housing investment remains sluggish and public investment is declining. While domestic demand has not shown clear 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. Corporate profits continue to recover, but the improvement in business sentiment as a whole has come to a halt due mainly to substantial uncertainty regarding the economic outlook. 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 with an ongoing decline in wages. 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 recent weakness shown in economic indicators of the U.S. and European economies amid greater uncertainty regarding Iraq-related developments. In this situation, the increase in Japan's 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 likely to follow a clear uptrend if exports and production increase clearly again, but for the time being, the increase in business investment is expected to remain very modest.

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, a self-sustaining recovery in domestic demand is unlikely to gain momentum 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 outlook for overseas economies warrants careful monitoring with more uncertain factors arising such as Iraq-related developments and economic implications of the severe acute respiratory syndrome (SARS). On the domestic side, careful monitoring is required of developments in stock prices and how they affect the financial system, corporate finance, and the economy.

On the price front, import prices are rising, reflecting developments in prices of overseas commodities such as crude oil. Domestic corporate goods prices have stopped declining on the whole with the rise in import prices and the improved supply-demand balance in materials industries, despite the

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on April 7 and 8, 2003.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on April 7 and 8, 2003 as the basis for monetary policy decisions.

continued fall in machinery prices. Meanwhile, consumer prices and corporate services prices have been declining gradually.

Looking at the conditions influencing price developments, the outlook for import prices is unclear at present because it largely depends on developments in crude oil prices. On the domestic side, the supply-demand balance in the macroeconomy, ongoing technological innovations in machinery, and the streamlining of distribution channels will continue to exert downward pressure on prices. In contrast, upward pressure is also at work, such as the effects of high crude oil prices to date and the improvement in the supply-demand balance in materials industries. Of these two opposite pressures, the latter will be slightly stronger at the corporate transaction stage for the immediate future, and therefore, domestic corporate goods prices are projected to inch up. As for the outlook, consumer prices are expected to continue decreasing but the pace of year-on-year decline 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 Bank of Japan provided further ample liquidity to secure financial market stability, following the commencement of military action against Iraq by the United States and other nations (March 20, Japan Standard Time). As a result, the outstanding balance of current accounts at the Bank rose to 30.9 trillion yen at the end of March. Under these circumstances, the overnight call rate continues to hover at very close to zero percent, although it rose temporarily on March 31. Longer-term interest rates such as TB and FB rates also rose temporarily toward the fiscal year-end, but they are becoming steady again at low levels.

Yields on long-term government bonds declined and were temporarily moving below the 0.7 percent level in early April, reflecting uncertainty over the domestic economic outlook. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds are contracting.

In the stock market, market participants continue to be nervous largely due to uncertainty over the developments in military action against Iraq. The Nikkei 225 Stock Average is recently moving at the 8,000-8,500 yen level.

In the foreign exchange market, the yen appreciated in early March as the U.S. dollar weakened on the whole. Since mid-March, however, the yen has been volatile reflecting the developments in military action against Iraq. The yen is currently traded in the range of 119-121 yen to the U.S. dollar.

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 overall environment for firms with low credit ratings remains severe although there seem to be slight improvements.

Credit demand in the private sector continues to follow a downtrend mainly because business fixed investment is at low levels 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 about 10 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 as a whole 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 continue to be 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.