

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

Bank of Japan, 16 September 2003.

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

Economic activity still continues to be virtually flat as a whole, although signs of improvement have been observed in such areas as the environment for exports.

With regard to final demand, business fixed investment is recovering gradually. Meanwhile, private consumption continues to be weak, housing investment remains sluggish, and public investment is declining. Net exports are virtually flat.

Industrial production continues to be basically level in response to these developments in final demand, and corporate profits are on a moderate uptrend. As for the employment situation, although the number of regular employees continues to decline, the total number of employees including both regular and non-regular employees has stopped falling. The pace of decline in wages has also slowed, and thus the decline in household income is gradually coming to a halt. However, the unemployment rate continues to be high, and hence the employment and income situation of households overall still remains severe.

Turning to the economic outlook, with respect to overseas economies, the likelihood is gradually increasing that the growth rate of the U.S. economy will accelerate and that the East Asian economies as a whole will resume a growth trend. Hence, exports and industrial production are likely to turn up gradually.

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 since the employment and income situation is unlikely to improve markedly. Meanwhile, the recovery trend in business fixed investment is expected to become clearer in the period ahead, mainly in large manufacturing firms, whose investment has been thus far significantly restrained despite the recovery in their profits. However, as long as the pace of increase in exports and production continues to be gradual, the recovery in business fixed investment is likely to remain moderate.

Overall, with the recovery in overseas economies, the uptrend in exports and production will resume gradually, which in turn will initiate the momentum for an economic recovery in Japan. However, a self-sustaining recovery in domestic demand is unlikely to gain momentum for some time due to persisting downward pressures from structural adjustments, such as firms' reduction of excess debt and labor costs. In addition, as for the outlook for the environment for exports, there still remains uncertainty overall, as the employment situation in the United States continues to be sluggish and the pace of recovery in some East Asian economies such as South Korea is slow. On the domestic side, continued attention should be paid to the developments in financial markets such as the volatile movements in long-term interest rates.

On the price front, import prices have recently stopped declining, reflecting the uptrend in international commodity prices, especially crude oil prices. Under these circumstances, domestic corporate goods prices are more or less flat, which is also partly due to the rise in tobacco tax. Meanwhile, corporate services prices continue a year-on-year decrease of slightly over 1 percent. Consumer prices also continue to decline, but the year-on-year rate of decrease has diminished to 0.2 percent due to special factors, such as the rise in medical treatment costs in April in line with the reform of the medical insurance system and the rise in tobacco tax in July.

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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 September 11 and 12, 2003.

<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 September 11 and 12, 2003 as the basis for monetary policy decisions.

Looking at the conditions influencing price developments, the outlook for import prices is unclear at present because it largely depends on developments in the foreign exchange rate. Turning to the domestic side, the basic conditions surrounding prices, such as the supply-demand balance in the macroeconomy, technological innovations, streamlining of distribution channels, and pricing strategies of firms, are unlikely to change significantly for the time being. Under these circumstances, domestic corporate goods prices are likely to remain more or less flat for the time being. Consumer prices are basically projected to continue falling at the current moderate pace on a year-on-year basis, although there are possibilities that the rate of decline may temporarily diminish further depending on future special factors.

As for the financial environment, the outstanding balance of current accounts at the Bank of Japan is moving at the 29-30 trillion yen level, as the Bank has been providing ample liquidity. Under these circumstances, the overnight call rate continues to move at around zero percent. Interest rates on term instruments remain steady. Meanwhile, interest rates on Euroyen futures are recently declining gradually after rising noticeably from late August.

Yields on long-term government bonds rose rapidly reflecting an improved outlook for Japan's economy, and are recently moving in the range of 1.4-1.6 percent. Meanwhile, yield spreads between private bonds (bank bonds and corporate bonds) and government bonds are widening slightly after the rebound in long-term interest rates.

Stock prices have been rising sharply as foreign investors continue to invest in Japanese stocks. The Nikkei 225 Stock Average is recently moving at around 10,500 yen.

In the foreign exchange market, the yen appreciated as foreign investors continued to invest in Japanese stocks. The yen is currently traded in the range of 116-118 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. Their lending attitudes seem to be becoming slightly more accommodative in areas such as terms and conditions for lending. Meanwhile, the lending attitudes of financial institutions as perceived by firms in general are improving somewhat, although those perceived by small firms remain severe. In the corporate bond and CP markets, the issuance spreads remain steady and the favorable issuing environment is virtually unchanged on the whole, especially for firms with high credit ratings, although some firms seem to be taking a wait-and-see stance in the corporate bond issuance market in view of the rise in long-term interest rates.

Credit demand in the private sector continues to follow a downtrend mainly because firms' cash flow remains above business fixed investment and firms are continuously reducing their debts.

Amid these developments, private banks' lending continues to decline at around 2 percent on a year-on-year basis. The amount outstanding of corporate bonds issued is around the previous year's level.

Meanwhile, according to business surveys, financial positions of firms in general are improving slightly, although those of small firms remain severe.

The year-on-year growth rate of the monetary base continues to be around 20 percent. The year-on-year growth rate of the money stock rose slightly and is at around 2 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. Meanwhile, long-term interest rates and stock prices are rising. Growth rates of the money stock and the monetary base relative to economic activity remain high. In corporate finance, the favorable issuing environment of corporate bonds and CP is virtually unchanged on the whole, especially for firms with low credit risks. However, there has been no significant change in the severity of fund-raising environment for firms, particularly with firms with high credit risks. Developments in the financial and capital markets, the behavior of financial institutions, and the situation of corporate finance continue to require close monitoring.