Bank of Japan's November report of recent economic and financial developments in Japan

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The Bank's View[1]

Japan's economic conditions still continue to deteriorate.

With respect to final demand, public investment orders have increased significantly. Net exports (exports minus imports) seem to be basically on an upward trend. Business fixed investment, however, has been declining under increasingly severe conditions for firms' fund-raising. Housing investment has also declined further. In addition, private consumption has shown some weakness. Against this background of weak final demand, production has been reduced substantially. As a result, inventories are decreasing, but the ratio of inventory to sales remains high due to sluggish shipments. With the decline in expenditure and production, corporate profits continue to worsen, and employee income is decreasing. Employment and income conditions have deteriorated as the ratio of job offers to applications has recorded a historical low and the unemployment rate remains at a high level.

As the above indicates, there remain continued negative interactions of production, income, and expenditure. In addition, there is a growing concern among firms for fund availability toward the ends of the calendar year and the fiscal year, given the increasingly cautious lending stance of financial institutions and the mounting difficulty in fund-raising in the capital market.

With the effects of the comprehensive economic stimulus package and the recent monetary easing, the deterioration of the economy is expected to moderate gradually. Nevertheless, the economy is hardly expected to recover immediately, judged from the strong negative interactions and the constraints from corporate finance mentioned above. Moreover, the appreciation of the yen since early autumn may exert pressures on corporate profits for the latter half of the fiscal year, and there is a growing uncertainty in financial and economic developments overseas. These additional factors also need careful monitoring. In the above circumstances, a new legal framework to rebuild the stability of the financial system was established in October. It is desirable that, based on this framework, banks' capital base should soon be strengthened sufficiently to restore market confidence. Furthermore, the government is planning to launch emergency economic measures by the middle of November. The materialization of these measures and their effects on corporate and household sentiment should be carefully monitored.

With regard to prices, wholesale prices are on a downtrend reflecting the continued expansion in the output gap. Corporate service prices are weakening further, and consumer prices have fallen below the previous year's level. Given the persistently strong negative interactions of production, income, and expenditure, the expansion in the output gap is unlikely to cease despite the expected effects of the comprehensive economic stimulus package. Furthermore, the continued decline in wages and the appreciation of the yen since early autumn will exert downward pressure on prices. Hence, the decline in prices, especially in wholesale prices, may somewhat accelerate in the future.

In the financial markets, interest rates on Euro-yen deposits maturing after the year-end rose after the middle of October. This is partly because Japanese financial institutions—facing the intensified severity in raising foreign currency funds as reflected in the expansion of the Japan premium—have raised yen funds vigorously to turn over the funds to foreign banks in exchange for foreign

[1] The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on November 13, as the basis of monetary policy decisions.

currencies. Meanwhile, Treasury bill (TB) rates lowered close to zero with an increase of TB purchase by foreign banks that had raised yen funds at very low rates.

The interest rate differential between Euro-yen deposits and TBs expanded considerably in parallel with the heightened market concern over Japanese banks' foreign currency liquidity risk at the year-end. Recently, however, the anxiety about worldwide credit crunch, which had once intensified in international financial markets, appears to be alleviated, and Japanese banks have shown considerable progress in raising foreign currency funds.

Stock prices have rebounded slightly, reflecting favorable market sentiments toward the enactment of laws aiming to stabilize and revitalize Japan's financial system and the movement of business tie-ups and restructuring in the financial industry. However, looking at the recent development of bond and stock markets as a whole, market participants seem to remain cautious over the outlook of the economy.

With regard to corporate finance, firms are further seeking to secure ample on-hand liquidity. Reflecting such increase in credit demand, the growth rate in M_2+CD continued to show a slight increase in September.

Meanwhile, Japanese private banks have taken more cautious attitude in extending loans, facing severe fund-raising environments and deteriorating business conditions of borrower companies. Particularly as the year-end nears, their cautious lending attitude seems to be adversely affecting not only small and medium-sized firms but also large ones.

In commercial paper and corporate bond markets, issuance rate differentials are further expanding across firms according to their creditworthiness. The development of severe corporate financial conditions toward the year-end and their influence on the economy continue to warrant careful monitoring.