

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

Bank of Japan, 21 March 2001.

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The Bank's view²

The recovery in Japan's economy has recently come to a pause, reflecting a decrease in exports.

With regard to domestic demand, business fixed investment is increasing. The recovery in private consumption continues to be weak as a whole, but there are somewhat positive signs in some indicators. Housing investment is virtually unchanged. Public investment is bottoming out.

While domestic demand remains steady, net exports (real exports minus real imports) are plummeting reflecting a sharp slowdown in overseas economies such as in the U.S. and East Asia. Mainly due to these developments, industrial production is starting to decline, and inventories of some materials and electronics parts are becoming excessive. Corporate profits continue to improve but the pace is thought to be slowing significantly, particularly in the manufacturing industries, as exports and production are recently weakening. Income conditions of households have not deteriorated but the effects of the decline in production are starting to be observed in new job offers and overtime working hours.

As for the outlook, public investment is expected to start increasing with the advance in the implementation of the supplementary budget for fiscal 2000. Net exports, however, are likely to continue decreasing for a while, as adjustments in overseas economies will take some time. Leading indicators suggest that business fixed investment is likely to peak out gradually, although there will be a backlog of orders to be implemented for a while. In addition, the need for inventory adjustments, although not to a large extent, is heightening for some goods. Thus, industrial production is expected to follow a declining trend. In these circumstances, the increase in corporate profits is likely to be subdued, and recoveries in household income and consumption are projected to be sluggish.

Overall, the economy will likely remain stagnant for some time. Meanwhile, it is generally thought that overseas economies, particularly the U.S., will follow a gradual recovery trend from the latter half of 2001. In this case, together with the effects from the depreciation of the yen, exports are expected to underpin the economy once again. However, attention should still be paid to the possibility of a prolonging deceleration of overseas economies and risks of a negative impact on the economy induced by developments in foreign and domestic capital markets through corporate and household confidence.

With regard to prices, import prices are rising, mainly reflecting the depreciation of the yen. Domestic wholesale prices are declining somewhat mainly due to the decrease in prices of electrical machinery. Consumer prices continue to be somewhat weak owing to the decline in prices of imported products and their substitutes. Corporate service prices are falling slowly.

As for the conditions surrounding price developments, the recent yen depreciation is exerting upward pressures on prices. However, given the pausing economy as well as the heightening excessiveness of inventories, albeit the latter is observed only for some goods, the balance between supply and demand in the domestic market is likely to exert downward pressures on prices. In addition, the declining trend of machinery prices caused by technological innovations, the decrease in prices of consumer goods arising from the streamlining of distribution channels, and the reduction in communications fees aided by deregulation will continue to restrain price developments. Overall, prices are expected to be somewhat weak for the time being. Moreover, given the high uncertainties

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on March 19, 2001.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on March 19 as the basis for monetary policy decisions.

regarding future economic developments, possibilities that weak demand will intensify downward pressures on prices warrant careful monitoring.

In the financial market, the overnight call rate generally moved around 0.25 percent in February, and is moving around 0.15 percent from March in response to the decision at the Monetary Policy Meeting held on February 28 to change the guideline of money market operations.³

Interest rates on term instruments are declining substantially due to the announcement of the improvements in the way of liquidity provision and monetary easing by the Bank. The Japan premium remains negligible.

Yields on long-term government bonds have declined to 1.1-1.2 percent due to the even more cautious view of market participants towards the economic outlook. The yield spreads between private bonds (bank debentures and corporate bonds) and government bonds are mostly unchanged or expanding somewhat.

Stock prices dropped substantially reflecting the decline in U.S. stock prices and the downward revision of the outlook on firms' profits.

In the foreign exchange market, the yen depreciated again from the end of February. The yen is currently being traded in the range of 122-124 yen to the U.S. dollar.

With regard to corporate finance, private banks continue to be more active in extending loans, mainly to blue-chip companies, while carefully evaluating the credit risks involved. There seem to be no significant changes in the fund-raising conditions of firms in the markets for such instruments as corporate bonds and CP.

On the other hand, credit demand of private firms continues to lack momentum as corporate demand for external funds is subdued, since firms' cash flow is at a high level. Moreover, firms continue to reduce their debts as part of their balance-sheet restructuring measures. As a result, credit demand in the private sector has continued to be basically stagnant.

In view of this, the underlying tone of private banks' lending remains sluggish, although the year-on-year rate of decrease moderated somewhat in January and February. Meanwhile, the amount outstanding of corporate bonds issued continues to be slightly above the previous year's level. The amount outstanding of CP issued remains at a high level.

Recently, the growth rate of money stock ($M_2 + \text{CDs}$) is increasing reflecting the inflow from postal savings.

As for funding costs for firms, both short- and long-term funding rates are declining reflecting the decrease in market interest rates.

In this financial environment, the lending attitude of financial institutions and corporate financing conditions remain easy. However, the effects of the decline in stock prices on the behavior of financial institutions and the fund-raising conditions of firms need to be carefully monitored.

³ "The Bank of Japan will encourage the uncollateralized overnight call rate to move on average around 0.15 percent."