

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

Bank of Japan, 15 October 2001

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

Adjustments in economic activity are becoming more severe, as the substantial decline in production has a negative influence on employment and income conditions. In addition, the terrorist attacks in the U.S. have further heightened uncertainty in Japan's economy.

With regard to final demand, net exports (real exports minus real imports) continue to decline, reflecting not only a slowdown in overseas economies but also sluggish demand for IT-related goods. Business fixed investment is also decreasing noticeably while exporting conditions continue to deteriorate. Housing investment remains sluggish and public investment is declining. Meanwhile, private consumption remains almost flat on the whole, although somewhat weak indicators are increasing recently.

Industrial production continues to decline considerably, reflecting these developments in final demand and also strong excessiveness in inventories of electronic parts and materials. The decrease in corporate profits, particularly in manufacturing, has become evident and household income weakens gradually.

Moreover, while such perception is becoming widespread that a further deceleration in overseas economies is inevitable due to the terrorist attacks in the U.S., precautions against the business outlook are intensifying among Japanese exporting firms.

Turning to the outlook, as for exporting conditions, although inventory adjustments in IT-related goods worldwide are expected to continue for the time being, the prevailing view is that the adjustments will be basically completed by around next spring. However, there exists a risk that the prolonged downturn in U.S. private consumption affected by the terrorist attacks would induce another round of adjustments in the Japanese economy, starting from the decline in exports such as of consumer goods. Under these circumstances for exports, uncertainty toward the economy is growing further. Meanwhile, with respect to domestic demand, business fixed investment is expected to follow a downward trend judged not only from the continuous decline in corporate profits, but also from the successive downward revisions of firms' investment plans in the IT-related sector. Private consumption is likely to weaken gradually along with the deteriorating employment and income conditions. Thus, the income-generating mechanism from corporate profits to employment and wages is starting to work adversely, and at the same time government spending is projected to follow a downward trend. Consequently, it may take quite a while for overall production activity to stop declining, although the decrease in the production of IT-related goods may eventually come to an end.

Overall, adjustments in economic activity, starting from the decline in exports since the beginning of this year, will surely affect domestic demand gradually. At the same time, concern that another substantial decline in exports will exert downward pressure on the economy is growing. Moreover, while the economy continues to be in a fragile state, continuous attention should be paid to the risk of a negative impact on the economy induced by developments in foreign and domestic capital markets via corporate and household confidence.

With regard to prices, import prices are declining mainly reflecting the softening of international commodity prices. Domestic wholesale prices are also declining somewhat faster because the effects from high crude oil prices and the depreciation of the yen in the past have dissipated, while prices of electrical machinery and materials continue to decrease. Consumer prices are weakening owing mainly to the decline in prices of imported products and their substitutes. Corporate service prices continue to decrease.

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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 October 11 and 12, 2001.

<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 October 11 and 12 as the basis for monetary policy decisions.

As for the conditions surrounding price developments, with the prolonged adjustments in economic activity, the balance between supply and demand in the domestic market will exert downward pressure on prices gradually. Furthermore, in addition to the declining trend of machinery prices caused by technological innovations, the decreases in the prices of goods and services reflecting deregulation and the streamlining of distribution channels will continue to restrain price developments. Overall, prices are expected to follow a gradual declining trend for the time being. Moreover, given the high degree of uncertainty regarding future economic developments, the possibility that weak demand will further intensify downward pressure on prices warrants careful monitoring.

In the financial market, the overnight call rate is moving around zero percent as the Bank of Japan provided ample liquidity to the money market by aiming at maintaining the current account balances held at the Bank at above 6 trillion yen due to the changes in the guideline for money market operations decided at the Monetary Policy Meeting held on September 18.

Interest rates on term instruments are basically level on the whole. The Japan premium remains negligible.

Yields on long-term government bonds are recently moving around 1.35-1.40 percent. As for the yield spreads between private bonds (bank debentures and corporate bonds) and government bonds, while spreads between bonds with relatively high credit ratings and government bonds remain mostly unchanged, those between bonds with low credit ratings and government bonds seem to be expanding somewhat.

Stock prices are recently starting to recover slightly.

In the foreign exchange market, the yen is currently being traded in the range of 120-122 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. However, the lending attitudes of financial institutions as perceived by small firms are becoming slightly more cautious. In corporate bonds and CP markets, the fund-raising conditions for firms continue to be generally favorable.

On the other hand, credit demand in the private sector is declining faster mainly because firms are decreasing their business fixed investment while continuously reducing their debts.

In view of this, private banks' lending is following a downward trend. The amount outstanding of corporate bonds issued is growing at about 2 percent on a year-on-year basis. Meanwhile, the amount outstanding of CP issued continues to be at a high level, significantly exceeding that of the previous year, due to the favorable environment for issuing CP.

The growth rate of money stock ( $M_2 + \text{CDs}$ ) in September was higher than that of the previous month.

Funding costs for firms continue to be at extremely low levels.

Overall, the recent financial environment remains extremely easy: witness the permeation of easiness in money market conditions, stably low interest rates, higher growth in monetary indicators, and the generally favorable conditions in corporate bonds and CP markets. However, against the background of deteriorating corporate earnings and the more cautious lending attitudes of financial institutions, fund-raising conditions of small firms are apparently becoming more severe. Hence, the developments in the behavior of financial institutions and corporate financing need closer monitoring.

In addition, it is necessary to carefully monitor the effects of the terrorist attacks in the U.S. and the subsequent developments on global financial markets and economic activity.