Bank of Japan's February report of recent economic and financial developments[1]

Bank of Japan, 12 February 2002.

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The Bank's View[2]

Japan's economy continues to deteriorate.

With regard to final demand, net exports (real exports minus real imports) tend to decrease at a slower pace since the decline in exports is moderating. Meanwhile, business fixed investment continues to decrease and private consumption is also weakening. Moreover, housing investment remains sluggish and public investment is on a downward trend.

Amid this weak final demand, inventory adjustment is progressing in many industries including electronic parts as a result of the large production cutbacks to date. Reflecting this development, the rate of decline in industrial production is contracting. However, firms maintain their stance on reducing personnel expenses under strong excessiveness in employment. Hence, the severity of employment and income conditions of households is rather intensifying, with unemployment continuing to rise and winter bonuses having decreased distinctly.

Turning to the outlook, with regard to exporting conditions, the synchronized inventory adjustment in IT-related goods worldwide is coming to an end. As a consequence, there seem to be signs that exports and production of the East Asian economies have stopped declining. Moreover, the yen has been depreciating recently. Under these conditions, exports are expected to stop decreasing and to turn up toward the middle of this year. However, exports will recover only modestly, while the recovery in overseas economies is weak and final demand for IT-related goods worldwide remains stagnant for the time being. As regards the U.S. economy, there are increasing number of indicators suggesting that the economy will hit the bottom, but there still remain many uncertain factors. Therefore, including this aspect, developments in overseas economies continue to require close scrutiny.

Meanwhile, with respect to domestic demand, business fixed investment is expected to follow a downtrend reflecting the fall in corporate profits. Private consumption is also likely to be weak mainly due to worsening employment and income conditions. Thus, while domestic private demand generally weakens, government spending is basically projected to follow a downward trend. Consequently, it may take quite a while for economic activity as a whole to stop declining, even though the decrease in industrial production may move toward cessation against the background of the improvement in exporting conditions and progress in inventory adjustment.

Overall, Japan's economy will continue to deteriorate, but the pace is expected to moderate gradually with the downward pressure from exports and inventories abating. Still, 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 from developments in foreign and domestic financial markets.

With regard to prices, import prices are rising as the decline in international commodity prices has stopped and the yen has been weakening. Domestic wholesale prices continue to decline as a whole mainly in machinery and chemical products, although the decrease in the prices such as of electronic parts seems to have ceased. Consumer prices are declining somewhat faster from the effects of the past decline in crude oil prices, while the prices of imported products and their substitutes continue to decrease. Corporate service prices continue to decline.

As for the conditions surrounding price developments, the effects of the past decline in crude oil prices are likely to continue for a time. On the other hand, the recent yen's depreciation is regarded as a factor to support prices in the period ahead. However, as the economy continues to deteriorate, the balance between supply and demand in the domestic market will keep exerting downward pressure on

[1] This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on February 7 and 8, 2002.

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

prices. 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 continues to move around zero percent as the Bank of Japan provided ample liquidity to the money market by aiming at maintaining the outstanding balance of the current accounts at the Bank at around 10 to 15 trillion yen.

Interest rates on term instruments are declining on the whole.

Yields on long-term government bonds rose slightly and are mainly moving in the range of 1.5-1.6 percent recently. Yield spreads between private bonds (bank debentures and corporate bonds) and government bonds remain mostly unchanged as a whole.

Stock prices continue to weaken.

In the foreign exchange market, the yen dropped slightly against the U.S. dollar mainly due to the widening gap between the U.S. and Japanese economic outlook.

With regard to corporate finance, private banks are becoming more 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 are gradually becoming more severe. In corporate bonds and CP markets, the fund-raising conditions are generally favorable particularly for firms with high credit ratings as seen in a slight decline in CP issuance rates, but the issuing environment for those with low credit ratings continues to be severe on the whole.

Credit demand in the private sector continues to follow a downtrend mainly because firms are decreasing their business fixed investment while continuously reducing their debts.

Amid these developments, private banks' lending continues to decline at about 2 percent on a year-on-year basis. As for the amount outstanding of corporate bonds issued, the year-on-year growth rate has been slowing since the issuance of corporate bonds with low credit ratings is sluggish. The year-on-year growth rate of the amount outstanding of CP issued is declining, although the amount is still well above the previous year's level.

The year-on-year growth rate of monetary base has increased further. The year-on-year growth rate of money stock (M_2 + CDs) continues to be around three to four percent.

Funding costs for firms continue to be at extremely low levels on the whole, although market funding costs for some firms and the long-term prime lending rate are rising somewhat.

Overall, the recent financial environment remains extremely easy on the whole in terms of money market conditions and interest rate levels. However, the fund-raising conditions of firms with high credit risks, especially of small firms, are becoming severe as private banks and investors are becoming more cautious in taking credit risks against the background of a growing number of corporate bankruptcies. Hence, the developments in the behavior of financial institutions and corporate financing need closer monitoring.