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

Bank of Japan, 13 June 2002.

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The Bank's view[2]

Japan's economy shows signs of stabilizing with a distinct increase in exports and a pick-up in production, although domestic private demand remains weak.

With regard to final demand, business fixed investment continues to decrease and private consumption, despite some resilience, remains weak as a whole. Moreover, housing investment remains sluggish and public investment is on a downtrend. Meanwhile, net exports (real exports minus real imports) are increasing markedly due to the recovery in overseas economies and also to the effects of restocking abroad, mainly in IT-related goods.

Industrial production is picking up, reflecting the increase in exports and completion of inventory adjustment. The rebound in production is beginning to affect employment conditions, albeit marginally, with an increase in overtime working hours and in new job offers mainly for part-time workers. Nevertheless, firms are still maintaining their stance on reducing personnel expenses from a longer term perspective and as a consequence, household income continues to decrease noticeably. In sum, employment and income conditions of households overall remain severe.

Turning to the outlook, exports are projected to continue to trend up mainly in IT-related goods amid the ongoing recovery in overseas economies, especially in the U.S. and East Asia. However, the pace of recovery is likely to become somewhat slower in the future than at present, as the effects from overseas restocking dissipate. Supported by this upturn in exports and also by the completion of inventory adjustment, industrial production is expected to accelerate momentarily followed by a gradual uptrend.

Meanwhile, with respect to domestic demand, public investment is projected to follow a declining trend and private demand is likely to remain weak for the immediate future. Nevertheless, if the increase in exports and production mentioned above continues, corporate profits will recover, particularly in the manufacturing sector, and this will gradually have a positive impact on domestic private demand such as business fixed investment.

Overall, Japan's economy is projected to stop declining as a whole since an increase in exports and production will lead to an improvement in corporate profits and in turn, domestic private demand. However, considering that forces restraining the economy stemming from excessive employment and debt are still persistently at work, it will take a while for the positive momentum to spread across the nonmanufacturing sector, small firms and households. The outlook for overseas economies, particularly for the U.S. economy, is also accompanied by various uncertain factors. Amid the persisting fragility and uncertainty of the economy, it should continue to be borne in mind that unstable movements in the foreign exchange and financial markets at home and abroad would easily exert a negative influence on the economy.

On the price front, import prices become almost unchanged because the continued upward pressure from the rise in crude oil prices around early spring is offset by the recent appreciation of the yen. Domestic wholesale prices are also almost flat since the decline in machinery prices and the reduction in electricity charges are offset by the effects of the increase in import prices in the past and of the progress in inventory adjustment. However, consumer prices and corporate service prices continue to decline.

As for the conditions surrounding price developments, the balance between supply and demand is expected to still keep exerting downward pressure on prices amid persistently weak domestic demand for a while, although the progress in inventory adjustment will support prices to some degree. Moreover, factors such as the ongoing technological innovations in machinery, deregulation, and the

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[1] This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on June 11 and 12, 2002.

[2] The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on June 11 and 12 as the basis for monetary policy decisions.

streamlining of distribution channels will continue to restrain prices. Under these circumstances, as import prices are likely to turn down, domestic wholesale prices, which are sensitive to import prices, will edge down after remaining flat a little further. On the other hand, consumer prices are expected to stay on a declining trend for the time being at the current gradual pace. This is partly because while the slower growth in imports of consumer goods is expected to alleviate the downward pressure on prices to some extent, the faster pace of decline in wages may possibly reinforce the ongoing decline in prices, especially for services prices.

As for the financial market, in the short-term money markets, the outstanding balance of the current accounts at the Bank of Japan is recently moving around 15 trillion yen as the Bank continues to provide ample liquidity to the money market.

In these circumstances, the overnight call rate continues to move around zero percent. Moreover, interest rates on term instruments remain steady.

Yields on long-term government bonds are mainly moving in the range of 1.3-1.4 percent recently. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds continue to contract. However, spreads between bonds with low credit ratings and government bonds still remain wide.

Stock prices are level on the whole and are basically moving in the range of 11,000-12,000 yen.

In the foreign exchange market, the yen continued to appreciate reflecting the overall downtrend in the U.S. dollar, but has been mixed thereafter since late May due mainly to the news on yen-selling intervention by the Japanese monetary authority.

With regard to corporate finance, private banks are becoming 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 becoming severe. In the corporate bonds and CP markets, the issuing environment for firms with low credit ratings remains severe, but the environment for firms with high credit ratings is on an improving trend.

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 by about 2-3 percent on a year-on-year basis. The year-on-year growth rate of the amount outstanding of corporate bonds issued is decreasing somewhat. The year-on-year growth rate of the amount outstanding of CP issued is declining recently, although the amount is still well above the previous year's level.

The monetary base continued to increase substantially by around 30 percent from the previous year's level in May, although the growth rate slowed slightly due partly to the abatement of liquidity demand prompted by a system failure of a major bank group. The year-on-year growth rate of the money stock (M_2 + CDs) remained around 3.5 percent.

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

Overall, the recent financial environment remains extremely easy on the whole in terms of money market conditions. The deterioration in the funding situation of firms is coming to a halt. However, the stance of investors toward firms with high credit risks remains severe and the lending attitudes of private banks are becoming more cautious. Hence, the developments in the behavior of financial institutions and corporate financing continue to require close monitoring.