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

Bank of Japan, 12 August 2002

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The Bank's View[2]

Japan's economy, despite persistent weakness in domestic demand and increasing uncertainty regarding the global economy, has almost stabilized as a whole with exports and production continuing to increase.

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 continues to decline. Meanwhile, net exports (real exports minus real imports) continue to increase significantly 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 clearly in response to the upsurge in exports and adequate reduction of excess inventory stocks. Against this background, corporate profits appear to have started to recover. In addition, the rebound in production is having effects on labor markets, albeit marginally, with an increase in overtime hours worked and in new job offers mainly for part-time workers. However, firms are still maintaining their stance on reducing personnel expenses and as a consequence, household income continues to decrease noticeably. Thus, employment and income situation of households overall remains severe.

Turning to the economic outlook, the upward trend in exports is expected to continue against the background of the gradual recovery in overseas economies, although the pace is likely to slow as the impetus from overseas restocking weakens. Thus, industrial production is expected to follow a gradual uptrend with some fluctuations in its pace.

On the other hand, 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. Yet, if the increase in exports and production mentioned above continues, the recovery in corporate profits will become distinct, and this will gradually bring a positive impact on domestic private demand. In fact, the decline in some leading indicators of business fixed investment has come to a halt.

Overall, it can be envisaged that the stabilization of Japan's economy will become more definite as the increase in exports and production, through the improvement in corporate profits, will underpin domestic private demand. However, considering that forces restraining the economy, such as excessive labor input and debt, are still persistently at work, momentum for a self-sustaining recovery will be subdued for some time. Furthermore, stock prices in the U.S. and worldwide as well as the U.S. dollar remain volatile and firms' outlook for the global demand for IT-related goods has become rather cautious. Judging from these factors, uncertainty regarding external conditions seems to have increased somewhat further. In these circumstances, it should continue to be heeded that further destabilization in the foreign exchange and financial markets at home and abroad could easily exert a negative influence on the economy.

On the price front, import prices have started to decline mainly due to the U.S. dollar's depreciation against the yen since this spring. Domestic wholesale prices have weakened, partly because the effects of the increase in import prices until spring started to dissipate. Moreover, consumer prices stay on a gradual downtrend and corporate services prices continue to decline.

As for the conditions surrounding price developments, the balance between supply and demand is expected to keep exerting downward pressure on prices for a while amid persistently weak domestic demand, although the completion of inventory adjustment and the rise in capacity utilization rates will

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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 August 8 and 9, 2002.

2 The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on August 8 and 9 as the basis for monetary policy decisions.

support prices to some degree. Moreover, factors such as the ongoing technological innovations in machinery, deregulation, and the streamlining of distribution channels will continue to restrain prices. With import prices beginning to decline, domestic wholesale prices are projected to continue to be weak for a while, as they are sensitive to import prices. Consumer prices are expected to stay on a declining trend for the time being at the current gradual pace. This is 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 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 at very close to zero percent. Also, longer-term interest rates remain steady.

Yields on long-term government bonds dropped to 1.26 percent in response to a further depreciation of the U.S. dollar against the yen and a decline in stock prices, and are recently mixed moving around 1.25-1.3 percent. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds are virtually level.

Stock prices declined from late July as foreign institutional investors sold stocks in line with a decline in U.S. and European stock prices, and are recently moving around 9,500-10,000 yen.

In the foreign exchange market, the yen rose to 115-116 yen in mid-July reflecting the overall downtrend in the U.S. dollar, and is currently fluctuating at around 120 yen to the U.S. dollar.

With regard to corporate finance, private banks remain 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 continue to be severe. In the corporate bonds and CP markets, the issuing environment for firms with low credit ratings is still severe, but the environment for firms with high credit ratings is accommodative.

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 rates of the amount outstanding of corporate bonds and CP issued are on a downtrend.

The monetary base increased substantially —by around 20-30 percent— from the previous year's level, although the growth rate slowed slightly. The year-on-year growth rate of the money stock 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 financing situation of firms has come to a halt. However, the stance of investors toward firms with high credit risks remains severe and the lending attitudes of private banks remain cautious. Hence, the developments in the behavior of financial institutions and corporate financing continue to require close monitoring.