

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

Bank of Japan, 20 November 2002

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

Japan's economy has stabilized as a whole, but there is greater uncertainty toward recovery.

With regard to final demand, while the decline in business fixed investment has almost come to a halt, private consumption continues to be weak. Moreover, housing investment remains sluggish and public investment is declining. While signs of recovery are still not observed in domestic demand, exports are losing their momentum.

The completion of the cutbacks in inventory stocks still underpins the increase in industrial production, but the pace of increase has become slower as exports are not rising anymore. As for the employment situation, the overtime hours worked continue to increase and the number of employees, which widely covers various non-regular employees such as temporary workers, appears to have stopped declining. However, as firms are still maintaining their stance on reducing personnel expenses, household income continues to decrease noticeably due to, among other factors, an ongoing decline in wages. Thus, the employment and income situation of households overall remains severe.

Turning to the economic outlook, a widely shared prospect for overseas economies throughout next year is that they will follow a gradual recovery path. However, an increasing number of economic indicators are softening in some countries, particularly in the United States. Based on this development, the recovery in overseas economies is likely to be anemic at least for the time being. Therefore, exports and industrial production are expected to be more or less unchanged for the immediate future.

With respect to domestic demand, public investment is projected to follow a declining trend and private consumption is likely to remain weak for some time due to the severe employment and income situation. Business fixed investment is expected to be supported by the improvement in corporate profits to date, but a distinct recovery is unlikely for the time being due to, among other things, greater uncertainty regarding overseas economies.

Overall, assuming that overseas economies will recover next year even at a moderate pace, the increase in exports and production will resume, making the foundations of Japan's economic recovery gradually firmer. However, the economy is unlikely to show clear signs of recovery for some time, since exports and production are expected to be virtually unchanged for the time being while restraining forces such as excessive labor input and debt persist. Furthermore, the uncertainty regarding the outlook for the U.S. and other overseas economies, including geopolitical factors and their effects on the economies, is becoming greater. On the domestic side, stock prices have fallen to a considerably low level. Hence, the progress in the disposal of non-performing loans of financial institutions and its effects on stock prices, corporate finance, and the economy, should be carefully monitored.

On the price front, import prices are starting to turn up reflecting the rise in oil prices during the summer and into the fall, and the depreciation of the yen. Domestic wholesale prices are virtually level since the rise in import prices and the improvement in the balance of supply and demand in the materials industries have almost been offset by the decline in machinery prices and electricity charges. However, consumer prices remain on a gradual downtrend and corporate services prices continue to decline.

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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 November 18 and 19, 2002.

<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 November 18 and 19 as the basis for monetary policy decisions.

Looking at the conditions influencing price developments, import prices are projected to continue firming up for the time being as the effects from the rise in oil prices will remain. However, the overall supply-demand condition 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 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. Under these circumstances, domestic wholesale prices are expected to remain virtually level for a while. Consumer prices are expected to stay on a declining trend for the time being at the current gradual pace. 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, the outstanding balance of the current accounts at the Bank of Japan is recently moving at around 17-18 trillion yen, as the Bank provides further ample liquidity following the guideline for money market operations decided at the Monetary Policy Meeting held on October 30. Under these circumstances, in the short-term money markets, the overnight call rate continues to move at very close to zero percent. Meanwhile, TB and FB rates, which declined temporarily after the Monetary Policy Meeting held on October 30, have inched up since mid-November as banks have held off buying TB and FB in response to a drop in bank stock prices.

Yields on long-term government bonds declined below 1.0 percent for the first time since November 1998 as banks and institutional investors increased investment in bonds, and are moving around 1.0 percent recently. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds remain virtually unchanged.

Meanwhile, stock prices declined and are recently moving around 8,000-8,500 yen due to rising uncertainty about the economic outlook.

In the foreign exchange market, the U.S. dollar is weakening again on the whole reflecting the strained situation in the Middle East and the deterioration in the U.S. economic indicators. The yen is currently being traded in the range of 119-122 yen to the U.S. dollar.

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 becoming slightly more severe. In the corporate bonds and CP markets, the issuing environment for firms with high credit ratings is accommodative, but the environment for firms with low credit ratings is severe.

Credit demand in the private sector continues to follow a downtrend mainly because firms' business fixed investment remains sluggish 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. Growth rates of the amount outstanding of corporate bonds and CP issued are on a declining trend and the amount outstanding dropped slightly below the previous year's level in October.

Meanwhile, according to business surveys, the financial position of firms, particularly that of small firms, remains severe.

The monetary base exhibits a high year-on-year growth rate of around 20 percent. The year-on-year growth rate of the money stock is around 3.0-3.5 percent.

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

Against the above background, the financial developments are summarized as follows. Money market conditions as a whole continues to be extremely easy partly due to the additional monetary easing by the Bank. Long-term interest rates are low. The money stock and the monetary base maintain high growth rates relative to that of the economic activity as a whole. However, stock prices remain unstable. In corporate finance, the fund-raising environment of firms with low credit risks is accommodative on the whole, but with regard to firms with high credit risks, the stance of investors remains severe and the lending attitudes of private banks are becoming more cautious. Under these circumstances, the government released the "Comprehensive Measures to Accelerate Reforms" which includes policies to accelerate the disposal of non-performing loans. Including the effects arising from these measures, developments in the financial and capital markets including stock prices, the behavior of financial institutions, and the situation of corporate finance require closer monitoring.