

Bank of Japan's December report of recent economic and financial developments¹

Bank of Japan, 18 December 2002

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The Bank's View²

Japan's economy has stabilized as a whole, but there is still substantial 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 virtually level.

The completion of the cutbacks in inventory stocks still underpins the increase in industrial production. But the production is losing its momentum with exports leveling off. Against this background, corporate profits continue to recover, but the pace is becoming moderate. While business sentiment on the current conditions is improving gradually, firms' outlook is cautious. As for the employment situation, the overtime hours worked and new job offers are rising gradually. In addition, the number of employees, which widely covers various non-regular employees such as temporary workers, appears to have stopped declining gradually. 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 the overseas economy throughout next year is that it will follow a gradual recovery path. However, economic indicators in the United States and in some other regions are soft on the whole. Based on this development, the recovery in the overseas economy 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 noticeable recovery is unlikely for the time being due to, among other things, substantial uncertainty regarding the overseas economy.

Overall, assuming that the overseas economy recovers next year even at a moderate pace, the increase in exports and production will resume sooner or later, which in turn will gradually make the foundations of Japan's economic recovery 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 downside risk on the outlook for the U.S. and other overseas economies continues to require attention, given that there are some uncertain factors including geopolitical developments and their economic implication. On the domestic side, stock prices remain unstable. Hence, the progress in the disposal of non-performing loans and its effects on stock prices, corporate finance, and the economy, should be carefully monitored.

On the price front, import prices are on the rise reflecting the earlier firmness in oil prices and depreciation of the yen. Domestic wholesale prices turned up slightly due to the increase in import prices and the improved supply-demand balances in the materials industries, although machinery

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on December 16 and 17, 2002.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on December 16 and 17 as the basis for monetary policy decisions.

prices and electricity charges are declining. However, consumer prices remain on a gradual downtrend and corporate services prices continue to decline.

Looking at the conditions influencing price developments, import prices are projected to be firm for the time being as the effects from the rise in oil prices and the depreciation of the yen still remains. 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 corporate goods prices, the new price indicator which will replace domestic wholesale prices from December, are expected to be 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 growth in imports of consumer goods has stalled and thus 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 environment, the outstanding balance of the current accounts at the Bank of Japan is recently moving at around 20 trillion yen, as the Bank provides further ample liquidity. Under these circumstances, in the short-term money markets, the overnight call rate continues to hover at very close to zero percent. Moreover, longer-term interest rates such as TB and FB rates continue to be at low levels as a whole, although the markets remain nervous reflecting weak bank stock prices.

Yields on long-term government bonds continue to move at around 1.0 percent. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds remain virtually unchanged.

Stock prices turned up in late-November, but weakened again in December in line with a decline in U.S. and European stock prices. The Nikkei 225 Stock Average is recently moving at around 8,500 yen.

In the foreign exchange market, the yen declined until the beginning of December reflecting the improvement in some U.S. economic indicators. Thereafter, the yen rebounded as the U.S. dollar weakened again on the whole due mainly to geopolitical factors. The yen is currently traded in the range of 120-122 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 have become slightly more severe. In the corporate bond 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. The growth rate of the amount outstanding of corporate bonds and CP issued is on a declining trend.

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 remains 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. 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 is severe and the lending attitudes of private banks are becoming more cautious. Hence, including the effects arising from government measures to accelerate the disposal of non-performing loans and to revitalize industries and firms, developments in the financial and capital

markets, the behavior of financial institutions, and the situation of corporate finance continue to require close monitoring.