

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

Bank of Japan, 17 February 2003.

* * *

The Bank's View²

Economic activity remains flat amid substantial uncertainty about the outlook for the economy.

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 domestic demand has yet to show signs of recovery, both exports and imports are increasing at a very modest pace with net exports remaining virtually level.

Industrial production continues to be basically level in response to these developments in final demand. As for the employment situation, new job offers are on a gradual rising trend. In addition, the number of employees, which covers various types of employees including non-regular employees such as temporary workers, appears to be declining at a slower pace. However, firms are still maintaining their stance on reducing personnel expenses, and household income continues to decrease significantly due mainly to an ongoing decline in wages. Thus, the employment and income situation of households overall remains severe.

Turning to the economic outlook, a widely shared view of the prospect for overseas economies in 2003 is that, partly due to the continued firmness in Asian economies, they will follow a gradual recovery path. However, their recovery is likely to be anemic, at least for the time being, given the recent deceleration of the U.S. economy and the weakness in European economies. In this situation, the increase in exports is expected to remain very modest, and industrial production is likely 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 mainly to substantial uncertainty regarding overseas economies.

Overall, assuming that overseas economies will recover in 2003, albeit only at a moderate pace, the increase in exports will accelerate and the uptrend in production will resume sooner or later, which in turn will initiate the momentum for a recovery. However, the economy is unlikely to show clear signs of recovery for some time, since production is expected to be virtually unchanged for the time being while downward pressures such as excessive labor input and debt persist. Furthermore, the downside risk to the economic outlook for overseas economies continues to require attention, given that there are some uncertain factors including geopolitical developments and their economic implications. On the domestic side, stock prices are weak. Hence, careful monitoring is required of progress in the resolution of the nonperforming-loan problem and its effects on stock prices, corporate finance, and the economy.

On the price front, import prices are on a rising trend with some fluctuations, reflecting developments in overseas commodity prices such as crude oil. Domestic corporate goods prices have been declining gradually due to the rise in import prices and the improved supply-demand balance in materials industries, despite the continued fall in machinery prices. Consumer prices and corporate services prices have also been declining gradually.

Looking at the conditions influencing price developments, import prices are projected to be firm for the time being due mainly to developments in crude oil prices. Although the low levels of inventories will

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on February 13 and 14, 2003.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on February 13 and 14, 2003, as the basis for monetary policy decisions.

support prices to some degree, the overall condition of supply and demand is expected to continue exerting downward pressure on prices while domestic demand continues to be weak for a while. Moreover, factors such as the ongoing technological innovations in machinery and the streamlining of distribution channels will continue to exert downward pressure on prices. Under these circumstances, domestic corporate goods prices are likely to continue a gradual decline for the time being. The pace of year-on-year decline in consumer prices is expected to become somewhat slower. This is because the year-on-year change in prices of petroleum products is expected to become positive, and medical costs are projected to rise from April due to public insurance reforms.

As for the financial environment, the outstanding balance of current accounts at the Bank of Japan is recently moving at around 20 trillion yen, as the Bank provides 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 continue to be at low levels as a whole.

Yields on long-term government bonds declined further in late January and are recently moving in the range of 0.8-0.9 percent. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds remain virtually unchanged.

Stock prices continue to be weak reflecting the uncertainty about the domestic economic outlook. The Nikkei 225 Stock Average is recently moving at around 8,500 yen.

In the foreign exchange market, the yen fell back slightly toward the end of January as market participants became sensitive to market intervention by the authorities, while the U.S. dollar has been weakening on the whole mainly due to the strained situation in the Middle East. The yen is currently traded in the range of 120-122 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, particularly small ones, are 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 business fixed investment remains sluggish and firms are 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 amount outstanding of corporate bonds and CP issued is moving at around the previous year's level.

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

The year-on-year growth rate of the monetary base dropped to around 10-15 percent in January. The year-on-year growth rate of the money stock is at around 2.0 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 continue to be extremely easy. Long-term interest rates remain at low levels. The money stock and the monetary base maintain high growth rates relative to that of economic activity as a whole. However, stock prices remain weak. 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 continue to be cautious. Developments in the financial and capital markets, the behavior of financial institutions, and the situation of corporate finance continue to require close monitoring.