

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

Bank of Japan, 21 March 2003.

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

Economic activity remains flat as a whole, but there is greater uncertainty about the economic outlook.

With regard to final demand, business fixed investment is recovering gradually, although one of the leading indicators suggests possible weakness ahead. Meanwhile, private consumption continues to be weak, housing investment also remains sluggish, and public investment is declining. While domestic demand has not shown clear signs of recovery, net exports remain virtually level.

Industrial production is 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 with the ongoing decline in wages. 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 is that the growth rate, especially that of the U.S. economy, will accelerate in the second half of this year with diminishing uncertainty regarding Iraq-related developments. For the time being, however, the recovery in the U.S. and European economies is projected to remain very modest. Moreover, there is rising concern that the growth of East Asian economies, which has been well-sustained so far, may slow at least temporarily, influenced by severe acute respiratory syndrome (SARS). In this situation, exports and also industrial production are expected to remain virtually level for the time being.

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 likely to follow a clear uptrend if exports and production increase clearly again, but for the time being, the increase in business investment is expected to remain very modest.

Overall, assuming that the growth rate of overseas economies accelerates in the second half of this year, the uptrend in exports and production will resume sooner or later, which in turn will initiate the momentum for an economic recovery in Japan. However, a self-sustaining recovery in domestic demand is unlikely to gain momentum 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. As to the outlook for the environment for exports, there is greater uncertainty about the effects of SARS within the East Asian region, whose economies are closely linked to Japan's, as well as uncertainty regarding the recovery in the U.S. and European economies and the developments in the U.S. dollar. On the domestic side, how the developments in the financial system will affect stock prices, corporate finance, and the economy requires careful monitoring.

On the price front, import prices are still increasing somewhat, reflecting the rise in crude oil prices until early spring. Domestic corporate goods prices have stopped declining on the whole with the rise in import prices and the improved supply-demand balance in materials industries, despite the continued fall in machinery prices. Meanwhile, consumer prices and corporate services prices have been declining gradually.

Looking at the conditions influencing price developments, import prices are expected to start declining, in reaction to the fall in crude oil prices since early spring. On the domestic side, the supply-demand balance in the macroeconomy, ongoing technological innovations in machinery, and the streamlining

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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 May 19 and 20, 2003.

<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 May 19 and 20, 2003 as the basis for monetary policy decisions.

of distribution channels will continue to exert downward pressure on prices. In addition, the improvement in the supply-demand situation in materials industries has recently come to a halt. Based on these factors, domestic corporate goods prices are projected to return to a gradual decline. Meanwhile, the pace of year-on-year decline in consumer prices is projected to slow somewhat in April with the rise in medical costs due to public insurance reforms. The year-on-year decline in consumer prices thereafter is projected to remain around the April level. While the rise in prices of petroleum products is expected to peak out, the import of consumer goods, which is strongly related to low-price strategies, is not increasing as it once was.

As for the financial environment, the outstanding balance of current accounts at the Bank of Japan moved in the range of 25-30 trillion yen during April, as the Bank provided more ample liquidity to secure financial market stability. Since the beginning of May, the Bank has been providing more ample liquidity in accordance with the guideline for money market operations decided at the Monetary Policy Meeting held on April 30. The outstanding balance of current accounts is recently moving at around 25-27 trillion yen. Under these circumstances, the overnight call rate continues to hover at very close to zero percent. Longer-term interest rates remain steady at low levels.

Yields on long-term government bonds declined and were temporarily moving at the 0.5-0.6 percent level, as banks and institutional investors have further increased investment in government bonds since the start of the new fiscal year. Yield spreads between private bonds (bank bonds and corporate bonds) and government bonds are contracting further due mainly to the increase in corporate bond investment by institutional investors.

Stock prices plunged temporarily toward the end of April reflecting uncertainty regarding the domestic economic outlook and concern over the worsening supply-demand situation in the stock market, but they have since recovered following the recovery in European and U.S. stock prices. The Nikkei 225 Stock Average is recently moving at around 8,000 yen.

In the foreign exchange market, the yen appreciated reflecting the ongoing weakness of the U.S. dollar due mainly to concern about increasing fiscal deficits and current account deficits in the United States. The yen is currently traded in the range of 115-118 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. Recently, their lending attitudes seem to be becoming slightly more accommodative in areas such as interest margin charges. Meanwhile, the lending attitudes of financial institutions as perceived by firms, particularly small ones, remain severe. In the corporate bond and CP markets, the issuing environment for firms with high credit ratings continues to be accommodative, and the environment for firms with relatively low credit ratings seems to be improving slightly.

Credit demand in the private sector continues to follow a downtrend mainly because business fixed investment is at low levels 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, but the rate of decline is contracting slightly. The amount outstanding of corporate bonds and CP issued is moving at around the previous year's level.

Meanwhile, according to business surveys, financial positions of firms, particularly those of small firms, remain severe.

The year-on-year growth rate of the monetary base is about 10 percent. The year-on-year growth rate of the money stock slowed somewhat and is around 1.5 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 continue to be extremely easy due partly to the additional monetary easing by the Bank. Long-term interest rates are declining further. The money stock and the monetary base maintain high growth rates relative to that of economic activity as a whole, although the rates have slowed somewhat. In corporate finance, the fund-raising environment has not changed significantly, that is, the environment for firms, particularly with high credit risks, remains severe, although slight improvements are observed such as in the issuing environment of corporate bonds and CP. Stock prices remain unstable. Under these circumstances, a meeting of the Financial System Management Council was held and it was decided that injection of capital into Resona Bank was necessary. Including the effects arising from the decision, developments in the financial and capital markets, the

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