

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

Bank of Japan, 16 July 2003.

* * *

The Bank's view²

Economic activity remains virtually flat.

With regard to final demand, business fixed investment is on a gradual recovery trend, albeit showing some fluctuations. Meanwhile, private consumption continues to be weak, housing investment remains sluggish, and public investment is declining. Net exports are virtually flat.

Industrial production continues to be basically level in response to these developments in final demand. Corporate profits continue to recover, although the pace is moderating. Under these circumstances, uncertainty regarding the economic outlook is diminishing somewhat, and business sentiment is improving to some extent, mainly among large manufacturing firms. As for the employment situation, the number of employees including non-regular employees such as temporary workers has almost stopped declining. However, the increase in the overtime hours worked and new job offers has come to a halt. Firms are maintaining their stance on reducing personnel expenses, and household income still continues to decrease as wages are on a downtrend, albeit gradual. 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 is that the growth rate, especially that of the U.S. economy, will accelerate in the second half of this year reflecting diminished geopolitical risks. For the time being, however, the pace of recovery in the U.S. economy is projected to remain very gradual. Moreover, economic activity in East Asia has decelerated somewhat, due partly to the slower growth of domestic demand in South Korea and the epidemic of severe acute respiratory syndrome (SARS). In this situation, both exports and industrial production are projected to remain virtually flat 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. Meanwhile, the uptrend of business fixed investment is expected to become established in the period ahead, mainly in large manufacturing firms, whose investment has been thus far significantly restrained despite the recovery in their profits. However, the pace of increase in overall business investment is likely to remain modest, as long as uncertainty regarding a recovery in exports and production remains.

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 gradually, 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 for the outlook for the external environment, although the downside risk has subsided slightly with the SARS epidemic coming to an end, there still continues to be substantial uncertainty about the recovery of the U.S. economy. On the domestic side, the recovery in stock prices is a positive factor. However, given the fragility of the financial system, attention should be paid to the possibility of a further upsurge in long-term interest rates and its influences.

On the price front, import prices and domestic corporate goods prices are declining, mainly reflecting crude oil prices that fell back in early spring. Corporate services prices continue a year-on-year

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on July 14 and 15, 2003.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on July 14 and 15, 2003 as the basis for monetary policy decisions.

decrease of slightly over 1 percent; the rate of decline expanded in April, as many firms repriced at the beginning of a new fiscal year. The rate of decline in consumer prices remains virtually unchanged from April, when the rate diminished due mainly to the rise in medical treatment costs in line with the reform of the medical insurance system.

Looking at the conditions influencing price developments, import prices are expected to continue declining for the immediate future, but are likely to stop declining before long since crude oil prices have recently been firm after they fell back in early spring. On the other hand, turning to the domestic side, the supply-demand balance in the macroeconomy, ongoing technological innovations in machinery, and the streamlining of distribution channels will continue to exert downward pressure on prices. In addition, the increase in domestic commodity prices has peaked out. Based on these factors, domestic corporate goods prices are likely to continue declining. Meanwhile, consumer prices are projected to continue falling at the current moderate pace on a year-on-year basis.

As for the financial environment, the outstanding balance of current accounts at the Bank of Japan is moving at around 29 trillion yen, as the Bank has been providing ample liquidity. Under these circumstances, the overnight call rate continues to move at around zero percent. Longer-term interest rates remain steady at low levels.

Yields on long-term government bonds declined further until mid-June, as investors increased their demand for the bonds. After that, the yields rose sharply partly because the bonds were sold at a profit on a large scale. Recently, they are moving at around 1.0 percent. Meanwhile, yield spreads between private bonds (bank bonds and corporate bonds) and government bonds continue to be at low levels.

Stock prices are recovering, reflecting a gradual improvement in market participants' view on the outlook for Japan's economy and foreign investors' active investment stance on Japanese stocks. The Nikkei 225 Stock Average is recently moving at the 9,500-10,000 yen level.

In the foreign exchange market, the yen depreciated toward the end of the month, due mainly to an improvement in some U.S. economic indicators. After that, the yen rebounded reflecting further investment in Japanese stocks by foreign investors, and is currently traded in the range of 117-119 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. 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 are improving somewhat, although small firms continue to perceive them as severe. In the corporate bond and CP markets, the issuing environment for firms with high credit ratings continues to be favorable on the whole, although some firms seem to be taking a wait-and-see stance in the corporate bond issuance market in view of the rise in long-term interest rates.

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 2.0-2.5 percent on a year-on-year basis. The amount outstanding of corporate bonds and CP issued is slightly above the previous year's level.

Meanwhile, according to business surveys, financial positions of firms are improving slightly, although those of small firms in particular remain severe.

The year-on-year growth rate of the monetary base rose and is around 20 percent. The year-on-year growth rate of the money stock is somewhat less than 2 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. Meanwhile, long-term interest rates are rising and stock prices continue to recover. The money stock and the monetary base maintain high growth rates relative to that of economic activity as a whole. 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 the issuing environment of corporate bonds and CP continues to be favorable, mainly for firms with low credit risks. Developments in the financial and capital markets, the behavior of financial institutions, and the situation of corporate finance continue to require close monitoring.