

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

Bank of Japan, 11 August 2003.

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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. As for the employment situation, the number of employees including non-regular employees such as temporary workers has almost stopped falling, and the pace of decline in wages has also slowed. However, the increase in the overtime hours worked and new job offers has come to a halt, and the number of regular employees continues to decline. Thus household income still seems to be on a gradual downtrend on average, and the employment and income situation of households overall remains severe.

Turning to the economic outlook, it is fairly possible that the growth rate of overseas economies, especially that of the U.S. economy, will accelerate in the second half of this year. However, as for the U.S. economy, although improvements have been observed in some recent economic indicators, careful examination is still required to judge to what extent business fixed investment and employment will increase following these developments. The pace of economic expansion in East Asia still remains slow compared to what it was a while ago, although there seem to be signs of recovery. In this situation, both exports and industrial production are projected to remain virtually flat 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 since the employment and income situation is unlikely to improve markedly. 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, with the anticipation that the growth rate of overseas economies will accelerate 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 immediate future while downward pressures such as excessive labor input and debt persist. In addition, as for the outlook for the external environment, there still remains uncertainty about, among other things, the recovery of the U.S. economy. On the domestic side, given the fragility of the financial system, continued attention should be paid to developments in stock prices and long-term interest rates.

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 decrease of slightly over 1 percent; the rate of decline expanded in April, as many firms reprice at the

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on August 7 and 8, 2003.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on August 7 and 8, 2003 as the basis for monetary policy decisions.

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. Hence domestic corporate goods prices are likely to continue a gradual downtrend, although the pace of decline will slow with the halt in the decline in import prices gradually having effects. 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. Interest rates on term instruments remain steady at low levels.

Yields on long-term government bonds have been declining gradually partly because investors bought medium- and long-term bonds on dips, and are recently moving at around 0.9 percent. Meanwhile, yield spreads between private bonds (bank bonds and corporate bonds) and government bonds continue to be at low levels on the whole, although those between bank bonds and government bonds are widening slightly.

Stock prices have become weak due mainly to a concern over the rapid increase in stock prices, even though market participants' view on the outlook for Japan's economy has been improving gradually. The Nikkei 225 Stock Average is recently moving at the 9,000-9,500 yen level.

In the foreign exchange market, the yen appreciated toward mid-July as foreign investors kept on investing in Japanese stocks, but it fell back as the dollar was purchased reflecting expectations for a recovery in the U.S. economy. The yen is currently traded in the range of 119-121 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 terms and conditions for lending. 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 still seem to be taking a wait-and-see stance in the corporate bond issuance market.

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 issued is slightly below 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 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 and stock prices are slightly declining. 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 on the whole, especially 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.