

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

Bank of Japan, 14 October 2003.

* * *

The Bank's View²

The foundation for a gradual recovery in Japan's economy is being laid, as the environment for exports and business sentiment have improved.

With regard to final demand, housing investment remains sluggish and public investment is declining. Private consumption also continues to be weak. Meanwhile, business fixed investment is recovering gradually and net exports have recently started to increase somewhat.

In response to these developments in final demand, corporate profits are following a moderate uptrend and business sentiment is improving, although industrial production is still basically flat. Meanwhile, the number of employees has stopped falling and the pace of decline in wages is gradually slowing. However, the employment and income situation of households overall still remains severe, as the unemployment rate continues to be high, albeit with some fluctuations.

Turning to the economic outlook, overseas economies are expected to maintain a relatively steady recovery mainly in the United States and in East Asia. Under these circumstances, it is likely that exports will continue to increase and industrial production will turn up gradually.

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 recovery trend in business fixed investment is expected to become clearer, mainly in large manufacturing firms, whose investment has been thus far significantly restrained despite the recovery in their profits.

Overall, with the recovery in overseas economies, exports and production will increase, which in turn will gradually initiate momentum for an economic recovery in Japan. However, it is expected to take some more time before a self-sustaining recovery in domestic demand gains momentum, given persisting downward pressures from structural adjustments, such as firms' reduction of excess debt and restraint on labor costs. In addition, uncertainty still exists with respect to the outlook for the environment for exports, as the employment situation in the United States continues to be sluggish and the yen exchange rate has been unstable, tending toward appreciation against the U.S. dollar.

On the price front, import prices have stopped declining due to the uptrend in international commodity prices, especially crude oil prices, until this summer. Under these circumstances, domestic corporate goods prices are more or less flat, which is also partly due to the rise in tobacco tax. Meanwhile, corporate services prices continue a year-on-year decrease of slightly over 1 percent. As for consumer prices, the year-on-year rate of decline diminished to 0.1 percent in August due mainly to the special factors, such as the increase in medical treatment costs in April and the rise in tobacco tax in July.

As for the outlook for prices, import prices are projected to head for a decline again due to the recent appreciation of the yen. Meanwhile, domestic corporate goods prices are likely to remain more or less flat for the time being, since there is some time lag for these import price developments to have effects on the domestic prices and also the rate of decline in machinery prices is diminishing. As for consumer prices, although it is possible that the year-on-year decline may stop temporarily in the period ahead due to special factors such as a rise in rice prices, they are basically projected to continue falling gradually, since the supply-demand condition in the macroeconomy still remains considerably loose despite its recent gradual improvement.

¹ This report is based on data and information available at the time of the Bank of Japan Monetary Policy Meeting held on October 9 and 10, 2003.

² The Bank's view of recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on October 9 and 10, 2003 as the basis for monetary policy decisions.

As for the financial environment, the outstanding balance of current accounts at the Bank of Japan moved almost at the 29-30 trillion yen level in September, as the Bank provided ample liquidity, but rose to 34.6 trillion yen on September 30 as a result of even more ample liquidity provision by the Bank. Under these circumstances, the overnight call rate moved at around zero percent, except for the temporary rise on September 30. Interest rates on term instruments remained steady on the whole, although TB and FB rates rose from mid to late September. Meanwhile, interest rates on Euroyen futures are declining gradually, although they were at somewhat high levels in September mainly in distant contracts.

Yields on long-term government bonds fluctuated due partly to portfolio adjustments toward the fiscal half year end under the improved outlook for Japan's economy. Recently, they declined slightly partly because investors bought government bonds on dips. The yields are moving at around 1.3 percent. Meanwhile, yield spreads between private bonds (bank bonds and corporate bonds) and government bonds are virtually unchanged on the whole.

Stock prices rose substantially toward mid-September as foreign investors continued to invest in Japanese stocks, but declined toward the end of September due to the rapid appreciation of the yen and growing concern over price adjustments. However, they recovered after the rebound in U.S. stock prices. The Nikkei 225 Stock Average is moving at around 10,500 yen.

In the foreign exchange market, the yen rose sharply as market participants became less sensitive to a possible market intervention around the time of the G-7 meeting and as foreign investors continued to invest in Japanese stocks. The yen is currently traded in the range of 109-111 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 loans. Meanwhile, the lending attitudes of financial institutions as perceived by firms in general are improving somewhat, although those perceived by small firms remain severe. In the corporate bond and CP markets, the issuance spreads remain steady and the favorable issuing environment is virtually unchanged on the whole, especially for firms with high credit ratings, although some firms still seem to be taking a wait-and-see attitude 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 firms' cash flow remains above business fixed investment and firms are continuously reducing their debts.

Amid these developments, private banks' lending continues to decline at around 2 percent on a year-on-year basis. The amount outstanding of CP issued is above the previous year's level. The amount outstanding of corporate bonds issued is around the previous year's level.

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

The year-on-year growth rate of the monetary base continues to be around 20 percent. The year-on-year growth rate of the money stock is around 2 percent.

Funding costs for firms continue to be at extremely low levels on the whole, although corporate bond issuance rates are increasing slightly reflecting the rise in long-term interest rates.

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 at a slightly lower level than last month. Stock prices are basically around the same level as last month. Growth rates of the money stock and the monetary base relative to economic activity remain high. In corporate finance, the favorable issuing environment of corporate bonds and CP is virtually unchanged on the whole, especially for firms with low credit risks. However, there has been no significant change in the severity of the funding environment for firms, particularly for firms with high 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.