Bank of Japan's February report of recent economic and financial developments[1]

Bank of Japan, Communication, 15 February 2000.

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The Bank's View[2]

Japan's economy has recently started to improve. The economic environment surrounding private demand is gradually improving, as seen in the continuing increase in corporate profits. However, clear signs of a self-sustained recovery in private demand have not been observed yet.

With regard to final demand, housing investment has peaked out and started to decline slowly, and public investment seems to be decreasing moderately. Recovery in private consumption continues to be weak with the decrease in income, particularly in winter bonuses. Business fixed investment, which had been on a downward trend, is starting to level off. Meanwhile, net exports (real exports minus real imports) continue to follow an upward trend, despite monthly fluctuations, due to an upturn in overseas economies.

Reflecting such developments in final demand and progress in inventory adjustment, industrial production continues to rise and an increase in corporate profits is becoming distinct. In this situation, corporate sentiment continues to improve. Regarding the employment condition, the decrease in the number of employees is gradually slowing. However, the improvements in corporate profits and sentiment have not stimulated business activities of many firms, because these firms still strongly feel that they have excess capacity and employees and that they should reduce their debts to restore financial soundness. In addition, efforts by firms to reduce personnel expenses have prolonged the severity of households' income conditions.

As for the outlook, improvements in the overall financial environment partly due to the monetary easing by the Bank, along with a series of economic measures taken by the government, are expected to continue underpinning the economy. Moreover, the positive impact on domestic production of the recovery of overseas economies is likely to continue for some time and have favorable effects on corporate profits and then on household income. By contrast, it is highly probable that housing investment will continue to decline slowly, and public investment is expected to follow a moderately downward trend for some time. In the corporate sector, restructuring is gradually improving profitability to some extent and some firms in high-growth sectors are inclining toward increasing capital spending. Many firms, however, are very likely to maintain a cautious stance toward fixed investment based on their modest prospects for sales. It seems that the appreciation of the yen since the summer of 1999 will have an adverse effect on corporate profits in the near term. In these circumstances, future economic developments still require careful monitoring in spite of the gradual recovery in the environment for private demand. Furthermore, it is important to promote structural reform in order to facilitate a recovery in private demand.

With regard to prices, import prices are rising somewhat due to the increase in international commodity prices such as crude oil prices, along with the recent depreciation of the yen. Domestic wholesale prices, notwithstanding the fall in prices of electric machinery, are flat mainly due to the

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[1] This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on 10 February 2000.

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

rise in prices of petroleum and chemical products reflecting an increase in crude oil prices. Consumer prices remain unchanged fundamentally. Corporate service prices are still falling slowly. As for the outlook, overall prices are likely to be flat for the time being despite the continued fall expected in prices of some machinery. This is because the supply-demand balance is improving gradually, as shown in the decline in inventories, and because the rise in crude oil prices to date will continue to be passed on to prices of other products for a while. However, attention should still be paid to the downward pressure on prices, as clear signs of a self-sustained recovery in private demand have not yet been observed and wages continue to fall.

Turning to the financial markets, the influence on the money market of concerns related to the Year 2000 problem has almost disappeared.

The overnight call rate has stayed at nearly zero, and financial institutions have been confident about the availability of overnight funds. The amount outstanding of funds in the call money market has been basically unchanged.

Interest rates on term instruments have generally been stable at the level as low as that prior to the emergence of concerns related to the Year 2000 problem. The Japan premium remains negligible.

Yields on long-term government bonds declined and, in late January, reached around 1.60-1.65 percent. But then they rebounded in reaction to the depreciation of the yen and the developments in the stock market, and are presently around 1.85 percent. The yield spread between private bonds (bank debentures and corporate bonds) and government bonds continues narrowing, primarily that between private bonds with relatively low credit ratings and government bonds.

Stock prices have been on a rising trend since mid-January against the background of the depreciation of the yen, and are currently moving around 19,500-20,000 yen.

In the foreign exchange market, the trend has been toward a weaker yen against the U.S. dollar, and the yen is being traded in the range of 107-110 yen.

With regard to corporate finance, private banks have basically retained their cautious lending attitude. However, constraint that had been caused by severe fund-raising conditions and insufficient capital base has eased considerably. Under these circumstances, major banks are gradually becoming more active in extending loans, while carefully evaluating the credit risks involved.

However, credit demand for economic activities such as business fixed investment remains weak. In addition, firms continue to reduce debts as part of their balance-sheet restructuring measures. As a result, credit demand in the private sector has continued to be basically stagnant, and thus private banks' lending has remained sluggish. Issuance of corporate bonds and CP has been sluggish.

The growth in money stock (M_2+CDs) continues to slow reflecting the stagnant private credit demand.

In this financial environment, the financial position of firms is easing, and the lending attitude of financial institutions as perceived by firms is becoming less severe. It continues to warrant careful monitoring how these favorable developments in corporate financing environment will affect economic activities.