

## **Bank of Japan's May review of monetary and economic trends in Japan**

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Japan's economy continues on a moderate recovery trend despite some fluctuations caused by the rise in the consumption tax rate, with private demand showing underlying firmness. With respect to final demand, public-sector investment has decreased, and housing investment has declined, reflecting the reversal in the stepped-up demand which took place ahead of the rise in the consumption tax rate. However, net exports have continued to rise and business fixed investment is increasing steadily. Despite the reversal in the stepped-up demand caused by the consumption tax rate hike, the recovery in personal consumption has not been hindered, given the moderate but firm recovery in labor market conditions and income formation. In these circumstances, industrial production has been firm to recover the level of inventories which declined owing to the temporary surge in demand ahead of the rise in the consumption tax rate. Meanwhile, prices have stopped declining, and growth in monetary aggregates has continued at around 3.0 per cent.

With regard to personal consumption, outlays for travel have continued to increase moderately. With respect to goods, sales particularly in expensive goods surged in March 1997 ahead of the rise in the consumption tax rate, followed by a decline in April as its reaction. Passenger-car sales recorded buoyant two-digit growth year-to-year for six consecutive months between October 1996 and March 1997, but showed a two-digit decline year-to-year in April. Although sales of electrical appliances, as well as sales at department stores and supermarkets, rose significantly in March 1997, April figures available for department stores in Tokyo are significantly below the previous year's level. However, the recovery trend in personal consumption do not seem to have been hindered, as labor market conditions as well as household income formation are improving steadily, albeit moderately.

Among leading indicators of business fixed investment, machinery orders have increased steadily. Construction floor area has also continued to recover moderately.

With respect to housing investment, housing starts in terms of the seasonally-adjusted annual rate reached a significantly high level in the fourth quarter 1996, partly reflecting the stepped-up demand ahead of the rise in the consumption tax rate. Later, they declined as the surge in demand reversed.

Regarding public-sector investment, the amount of public works contracted has quite recently picked up somewhat, reflecting orders included in the supplementary budget for fiscal 1996. However, public-sector investment has been on a declining trend since spring 1996 when orders from the large economic stimulus package peaked out.

Real exports are increasing, reflecting the moderate expansion of overseas economies and the effects of the yen's depreciation between mid-1995 and April 1997. Real imports have also continued to increase, reflecting such elements as the rise in domestic demand. However, growth has been moderate compared to that in exports against the background of the narrowing price differentials between home and abroad caused by the yen's depreciation. Reflecting these developments in exports and imports, the real trade surplus has been rising since the second half of 1996. The nominal current-account surplus is also increasing, but its increase has been more moderate owing to rising crude oil prices until early 1997 and fluctuations in the income account.

Industrial production increased at a significant pace in the fourth quarter 1996 and the first quarter 1997. Industrial production in April and May is expected to remain virtually

unchanged at the level recorded in the first quarter 1997 despite the reversal in the surge in final demand. This has partly been supported by the recovery in inventories from the low level at the end of March 1997 created by the temporary surge in demand ahead of the consumption tax hike.

Labor market conditions have continued to improve moderately on the whole. Although the unemployment rate remains at a high level and employment growth has been moderate, growth in nominal wages has been accelerating somewhat, reflecting the increase in production and corporate profits. The ratio of job offers to job applications has continued to improve.

Prices have stopped declining. Domestic wholesale prices (adjusted for seasonal electricity rates) rose by almost 2 per cent in April 1997, as the rise in the consumption tax rate was almost fully passed on to prices. Downward pressures remain strong, including those from technological innovation, such as in electrical machinery, but domestic wholesale prices have remained unchanged or have risen marginally. This reflects the yen's depreciation and higher oil prices to date, as well as the moderate improvement in domestic supply and demand conditions. The year-to-year declines in corporate service prices are narrowing steadily, mainly owing to the improvement in supply and demand conditions, although leasing charges continue to decline. In consumer prices (nationwide, excluding perishables), overall consumer prices are marginally above the previous year's level mainly because the year-to-year declines in goods prices have slowed.

Growth in monetary aggregates, measured in terms of the year-to-year growth rate of M2 + CDs average outstanding, has slowed somewhat compared to that in summer 1996, reflecting the shift of assets to those outside M2 + CDs. Recently, M2 + CDs average outstanding grew at around 3 per cent on the whole.

Regarding money market rates, the overnight call rate (uncollateralized) has moved at a level slightly below the official discount rate. The 3-month CD rate has stayed at around 0.55 per cent. Meanwhile, the long-term government bond yield declined to a record low of below 2.1 per cent in early April 1997. However, it recently rose to around 2.5 per cent as market uncertainties about the economic outlook and about Japanese financial institutions have gradually subsided in line with developments in the stock market.

With respect to bank lending rates, the short-term prime lending rate has remained at a record low level of 1.625 per cent since September 1995. The long-term prime lending rate had been moving at the record low of 2.5 per cent since December 1996. Reflecting movements in long-term interest rates, however, it was raised by 0.6 percentage points to 3.1 per cent in May 1997.

On the stock exchange, the Nikkei 225 stock average has been rising since the second half of April 1997, reflecting the fact that market uncertainties about the economic outlook and about Japanese financial institutions have gradually subsided, and the strong U.S. stock prices. In early May, it recovered to above ¥20,000 for the first time in four and a half months, and has recently continued to move at around ¥20,000.

In the foreign exchange market, the yen depreciated between April and early May to around ¥126 - 127 to the U.S. dollar. However, the yen's depreciation was later reversed rapidly, as concerns about the appreciation of the U.S. dollar strengthened, and as the differential in interest rates between Japan and the United States narrowed somewhat. The yen has recently

moved at around ¥116 - 117 to the U.S. dollar. Meanwhile, the yen has appreciated against the deutsche mark and recently has moved at around ¥68.