

## **Bank of Japan's May report of recent economic and financial developments**<sup>1</sup>

Bank of Japan communication, 21/5/98.

### The Bank's view

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Japan's economy remains stagnant with continued strong downward pressures on economic activities.

With respect to final demand, public-sector investment seems to have bottomed out. However, growth in net exports has virtually peaked out as exports to other Asian countries decline. Business fixed investment has been on the decline. Private consumption shows no sign of recovery although the deterioration has slowed. Housing investment remains weak. Against the background of weak final demand, inventories have accumulated further and industrial production continues to decline. As a result, not only corporate profits but also employment and income conditions have worsened significantly.

The above indicates that production, income, and expenditure show negative interactions with one another. In these circumstances, the economic stimulus package was decided, and the fiscal 1998 supplementary budget bill was submitted to the Diet. These measures are expected to boost demand through additional fiscal expenditure and special income tax-reduction and thereby alleviate the downward pressures on the economy. In order for the Japanese economy to resume a self-sustained recovery, improvements in corporate and household confidence are vital. Hence, the overall economic activity and the effects of the economic stimulus measures should be carefully monitored.

With regard to prices, wholesale prices continue to fall, and the year-to-year increase in consumer prices (excluding the effects of institutional changes such as the rise in the consumption tax rate) has been declining close to zero. As for the future, the downward pressure on domestic prices, induced by the decline in import prices including overseas commodity prices, is weakening. Also, the expansion in the output gap in the economy is expected to slow as the economic stimulus package is implemented. In the immediate future, however, prices are likely to weaken reflecting the present high inventory level and the relatively large output gap.

In the financial markets, both long and short-term interest rates followed a declining trend with the releases of weak economic indicators. Yields on long-term government bonds have recorded a historical low and stock prices remain soft. The yield differential between bonds issued by the private sector and those by the government, as well as the so-called "Japan premium", has remained at the relatively high level and shown no significant decrease, indicating the continuing cautious attitudes of market participants toward credit risk.

With respect to monetary aggregates, the growth in  $M_2$ +CDs, which had picked up from the end of 1997, slowed in March and April. Also, the growth in broadly-defined liquidity has been declining since the middle of 1997.

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<sup>1</sup> This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on May 19, 1998.

<sup>2</sup> The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on May 19, as the basis of monetary policy decisions.

Private bank lending remains sluggish. Although corporate financing via the capital markets and government financial institutions continues to expand, the increase in overall corporate financing seems to indicate a clear slowdown under the stagnant economic conditions.

Banks remain cautious in extending loans with a view to improving their medium-term profitability and financial soundness. In the capital markets, the difference in fund-raising costs of firms has remained relatively large according to their creditworthiness. In such circumstances, some firms, especially small and medium-sized firms, have been facing difficult financing conditions and this influence on the economy continues to warrant a careful monitoring.

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