

The Bank's View<sup>2</sup>

Final demand remains weak and production has declined significantly. Employment and income conditions continue to deteriorate, and corporate sentiment is weakening further. As a whole, Japan's economic conditions have deteriorated.

With respect to final demand, public-sector investment seems to have bottomed out. Net exports, which decreased temporarily in the first quarter of 1998, have resumed to increase mainly due to a sharp decline in imports. Business fixed investment, however, has decreased significantly, and housing investment remains weak. Private consumption has shown little sign of recovery, although the deterioration has stopped. Against the background of weak final demand, the level of inventories remains high, and the decline in industrial production is accelerating. As a result, corporate profits have further decreased, and employment and income conditions have deteriorated conspicuously as seen in the fall in wages below the previous year's level.

Although the above indicates negative interactions of production, income, and expenditure, a further deterioration in the economy is expected to cease as the effects of the comprehensive economic stimulus package, including additional public works and the special income tax reduction, become full scale. However, given the current considerably low level of economic activities, the positive influence of the package on private demand will likely be limited, and the economy's immediate transition to a self-sustained recovery is hardly expected. In these circumstances, measures to rebuild the stability of the financial system have been devised, and the reform of the taxation system is expected to be discussed actively. The materialization of these policies along with the effects on corporate and household sentiment should be carefully monitored.

With regard to prices, wholesale prices continue to fall, and consumer prices (excluding the effects of institutional changes) have declined slightly below the previous year's level. With respect to the factors affecting the outlook, the downward pressure on domestic prices induced by the decline in import prices is weakening. In addition, the expansion in the output gap in the economy is expected to slow in line with the implementation of the comprehensive economic stimulus package. Nevertheless, reflecting the present large output gap, the downward pressure from domestic factors is unlikely to weaken considerably, and hence, prices are likely to be weak for some time.

As for financial markets, stock prices and yields on long-term government bonds have rebounded since mid-June 1998. This may be attributed to a slight recovery in market sentiment, although still weak, responding to the announcement of the Comprehensive Plan for Financial Revitalization, the so-called Total Plan, and to the emergence of expectations for permanent tax cut.

In money markets, with the heightened awareness toward financial problems at a bank, concerns over credit risks of financial institutions strengthened once again, and upward pressure on interest rates suddenly mounted toward the end of June. However, with the ample provision of funds by the Bank of Japan and the announcement of the Total Plan, market anxieties settled down, and the upward pressure on interest rates gradually eased.

With respect to monetary aggregates, growth in  $M_2$ +CDs has been slowing, reflecting the sluggish private bank lending. These developments appear to strongly reflect the further decline in credit

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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 July 16, 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 July 16, as the basis of monetary policy decisions.

demand of private firms with the worsening of overall economic activities, and the continued cautious attitudes of private banks in extending loans.

Meanwhile, some firms, especially small and medium-sized firms, have been facing difficult financing conditions in terms of both funds availability and fund-raising costs. This influence on the overall economy continues to warrant careful monitoring.