

**Bank of Japan's September report of Recent Economic and Financial Developments** BANK OF JAPAN COMMUNICATION, 11/9/98.

**The Bank's View<sup>1</sup>**

Japan's economic conditions continue to deteriorate.

With respect to final demand, public investment seems to have bottomed out. Net exports (exports minus imports) are increasing mainly due to a decline in imports. However, business fixed investment has been decreasing significantly, and housing investment has declined further. Private consumption has not yet shown a recovery despite the special income tax reduction. Against this background of weak final demand, production has been reduced substantially. As a result, some industries have shown improvements in inventory adjustments, but the level of inventories is still high as a whole. With the decline in expenditure and production, corporate profits continue to decrease, and the decline of employee income is accelerating somewhat. In addition, the ratio of job offers to applications records a historically low level, and the unemployment rate remains at a high level. As a whole, the employment and income conditions have deteriorated further.

As the above indicates, there are continued negative interactions of production, income, and expenditure. Given the current considerably low level of economic activities, the economy is unlikely to transit immediately to a self-sustained recovery led by private demand, although a further deterioration in the economy is expected to cease gradually from the effects of the comprehensive economic stimulus package. Additionally, attention should be paid to possible negative effects on the real economy from financial developments including the recent fall in stock prices. In these circumstances, the cabinet approved a guideline on budget requests by ministries for fiscal 1999. This guideline intends to stimulate the economy by allocating ¥4 trillion to the special budgetary provision on the condition that the Fiscal Structural Reform Act is suspended. In addition, the bills to rebuild the stability of the financial system are being deliberated at the Diet, and the reduction exceeding ¥6 trillion in personal income taxes and corporate taxes is expected to be discussed in detail. The materialization of these policies along with their effects on corporate and household sentiment should be carefully monitored.

With regard to prices, wholesale prices are on a downtrend, and consumer prices are lowering below the previous year's level. With respect to the outlook, the downward pressure from domestic factors is unlikely to weaken considerably reflecting the already large output gap, despite the expected effects of the comprehensive economic stimulus package. Hence, prices are likely to be weak for some time.

In the financial markets, stock prices dropped considerably in late August and still remain unstable, due to the heightened uncertainty over the problems with the financial system and the worldwide stock market plunge triggered by Russia's financial crisis. Meanwhile, interest rate spreads, such as the rate differential between Euro-yen deposits and treasury bills, the Japan premium, and the yield differential between private and government bonds, expanded against the background of intensified market concern toward credit risks of Japanese financial institutions. Nevertheless, both long- and short-term interest rates declined slightly as a whole, which seemingly indicates that some market participants anticipated additional monetary easing.

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<sup>1</sup> The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on September 9, as the basis of monetary policy decisions.

With respect to corporate finance, some firms are moving to resume securing on-hand liquidity against the cautious lending stance of private banks, although credit demand for real economic activities remains sluggish. Consequently, the issuance of corporate bonds and commercial paper continues to increase, and the private bank lending, measured by annual percent changes, has escaped further decline so far. In addition, the growth of money stock appears to hold back its recent decelerating trend.

However, some firms, especially small and medium-sized ones, continue to face a severe environment in terms of both funds availability and fund-raising costs. This influence on the economy continues to warrant careful monitoring.