

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

Bank of Japan, Communication, 16/02/99.

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

The economic deterioration in Japan has become moderate against the background of the increase in public investment.

Business fixed investment has been declining significantly. As for housing investment, housing starts are bottoming out but remain at a low level. Recovery in private consumption has been weak on the whole, although partial improvement in sales of goods has been observed. Meanwhile, net exports (exports minus imports) basically remain on a gradually increasing trend, and public investment is increasing considerably. Reflecting this development of final demand and the continued progress in inventory adjustments, industrial production, which had been on a downtrend, is leveling off.

Corporate profits continue to decline. Employment and household income conditions are still deteriorating as the unemployment rate is at a historically high level, and winter bonuses have decreased significantly. Conditions in corporate finance are currently improving, but firms apparently cannot remove their anxiety about the availability of funds in the future. Consequently, corporate and household sentiment remains cautious, and a recovery has not yet been observed in private demand.

As for the future developments, the increase in public investment is likely to underpin the economy toward the first half of fiscal 1999 with the implementation of the government's economic measures. Furthermore, the Bank's monetary and financial measures and the government's measures to alleviate the credit crunch will continue to be in effect. Nevertheless, an immediate self-sustained recovery in private demand is hardly expected, since corporate profits and household income are still deteriorating and the constraints from corporate finance are likely to persist for some time due to cautious lending attitudes of private banks. Moreover, attention should be paid to (1) the effects of the continued appreciation of the yen since autumn 1998; (2) those of the recent rise in long-term interest rates; and (3) the uncertainty in financial and economic developments abroad. To lead Japan's economy into a steady recovery, it is important to prepare an environment where firms and households can regain confidence in Japan's economic future by, for instance, promptly restoring the stability of the financial system.

With regard to prices, reflecting the large output gap, domestic wholesale prices are on a downtrend, and corporate service prices are weakening. Consumer prices have increased above the previous year's level due to the rise in prices of perishables. Excluding this temporary effect, consumer prices basically remain weak. As for the outlook, although public investment is expected to increase, distinct narrowing in the output gap is hardly expected toward the first half of 1999, as private demand is likely to remain sluggish. Furthermore, the decline in wages and the appreciation of the yen since autumn 1998 are likely to continue exerting downward pressure on prices. Hence, prices are expected to remain on a downtrend.

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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 February 12, 1999.

<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 February 12, as the basis of monetary policy decisions.

In the financial markets, the Japan premium and Euro-yen interest rates (both on three-month contracts) remain stable despite the approach of the fiscal year-end. This reflects the abatement of the market's anxiety about liquidity and credit risks of Japanese banks against the background of the Bank of Japan's maintenance of a decisive stance on easy monetary policy as well as the formulation of the framework to restore the stability of Japan's financial system.

Yields on Japanese government bonds have risen again reflecting the market's concern over the prospective expansion of fiscal deficits. In the foreign exchange market, the trend has been toward a higher yen. Stock prices continue to be weak. Considering that these developments can be a hindrance to an economic recovery, their ensuing developments require close attention.

With regard to corporate finance, credit demand for economic activities remains weak, as a result of the significant decrease in business fixed investment. Firms' moves to increase their on-hand liquidity in the face of difficult fund-raising conditions are gradually settling down. Although private banks have basically retained their cautious lending stance, they continue to actively utilize the credit guarantee system. As a result, the previously tightened credit conditions are easing somewhat.

Nevertheless, private banks and capital market participants are still cautious of corporate credit risk, and thus firms with relatively low credit ratings remain under severe fund-raising conditions.

The situation continues to warrant careful monitoring, particularly with regard to how corporate finance develops toward the end of the fiscal year.

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