

Bank of Japan's March report of recent economic and financial developments¹

Bank of Japan, Communication, 16 March 1999.

The Bank's View²

Japan's economy, at present, appears to have stopped deteriorating. With the increase in public investment underpinning final demand, inventory adjustment has made further progress and production has stopped decreasing.

With regard to final demand, business fixed investment has been declining significantly. Recovery in private consumption continues to be weak on the whole, although partial improvement in sales of goods has been observed. Housing investment remains at a low level but has obviously bottomed out. Net exports (exports minus imports) are leveling off, and public investment is growing considerably. Reflecting this development of final demand and further progress in inventory adjustment, industrial production has stopped decreasing. However, corporate profits have been declining, and employment and household income conditions continue to deteriorate. Although conditions in corporate finance are improving, firms apparently cannot remove their concern about the availability of funds in the future. Consequently, corporate and household sentiment remains cautious.

As for the outlook, with the progress in inventory adjustment gradually paving the way for a recovery in production, the government's economic measures and the monetary easing by the Bank would underpin the economy. In addition, measures to restore the stability of the Japanese financial system – especially the injection of public funds into banks – are expected to exert positive effects on the economy gradually. With respect to corporate activities, however, large firms in particular appear to take steps to full-scale restructuring over fiscal 1999, facing the continued decline in profits and the remaining concern about their financing. In the short run, such corporate restructuring may reduce fixed investment and discourage household expenditure through the resulting deterioration in employment and income conditions. Under such circumstances, it is still difficult to expect an immediate, self-sustained recovery in private demand. Overall economic developments require careful monitoring in consideration of the above points.

With regard to prices, reflecting the large output gap, domestic wholesale prices are on a downtrend, and corporate service prices are weakening. Consumer prices basically remain weak. In relation to price developments in the future, distinct narrowing in the output gap is unlikely for the time being even though the economy appears to have stopped deteriorating. 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.

In the financial markets, the additional monetary easing by the Bank on February 12 has lowered interest rates both on overnight call money and term instruments. In addition, the markets' anxiety about liquidity and credit risks of Japanese banks seems to have subsided –

¹ This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on March 12, 1999.

² The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on March 12, as the basis of monetary policy decisions.

as reflected in a rapid contraction in the Japan premium – partly due to the progress in preparation for public funds injection.

Meanwhile, the amount outstanding of funds in the call money market has decreased, partly because some institutional investors have shifted a part of their funds from the market to ordinary deposits. The shrinkage of the market has not led to any difficulty in funds settlement. However, close attention should be paid to developments in the flow of funds as unexpected changes may occur.

Long-term interest rates have, amid nervous market sentiment, declined following the fall in short-term rates. Stock prices have turned to be firm against the background of the recent depreciation of the yen and the rise in U.S. stock prices.

With regard to corporate finance, credit demand for economic activities such as fixed investment remains weak. Firms' moves to increase their on-hand liquidity in the face of difficult fund-raising conditions are settling down. Meanwhile, private banks have basically retained their cautious lending stance, facing the worsening performance of borrower companies. However, severity in their fund-raising conditions has been alleviated, and their insufficient capital base is about to be increased. Under these circumstances, banks continue to actively utilize the credit guarantee system.

As a result, the previously tightened credit conditions are easing somewhat. Nevertheless, the market is still cautious of credit risk, and thus firms with relatively low credit ratings seem to remain under severe fund-raising conditions.

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