

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

Bank of Japan, Communication, 20 May 1999.

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

Japan's economy, at present, has stopped deteriorating, but clear signs of recovery have not been observed yet.

With regard to final demand, business fixed investment has been on a downward trend, and recovery in private consumption continues to be weak on the whole. Net exports (exports minus imports) are leveling off. Meanwhile, housing investment has been recovering. Public works seem to be increasing rapidly against the background of the large increase in orders in early spring.

Reflecting such developments in final demand and continued progress in inventory adjustment, industrial production has stopped decreasing. The deterioration in corporate and consumer sentiment seems to have ceased due to this economic situation as well as the improvements in the financial environment, including the subsidence of the public's anxiety about the stability of Japan's financial system and the recovery in stock prices. However, corporate profits remain weak, and employment and household income conditions are deteriorating as the unemployment rate has been marking a historical high. Conditions in corporate finance continue to improve, but firms' concern about the availability of funds in the future has not completely disappeared yet.

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 will continue to underpin the economy. Improvements in the financial environment are also expected to exert positive effects on the economy gradually. With respect to corporate activities, however, firms have started taking steps toward full-scale restructuring, facing the continued decline in profits. Although such corporate restructuring is expected to improve productivity, it may, in the short run, 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. It is also important to promote structural reform, while preparing an environment that facilitates such reform, in order to assure the economy's sustained growth in the medium term.

With regard to prices, reflecting the large output gap, domestic wholesale prices are on a downtrend, and corporate service prices are weakening. Import prices are rising due to the bottoming out of international commodity prices such as crude oil prices. Consumer prices remain weak. In relation to price developments in the future, distinct narrowing in the output gap is still unlikely for the time being even though the economy has stopped deteriorating.

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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 18, 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 May 18 as the basis of monetary policy decisions.

Furthermore, the decline in wages is likely to continue exerting downward pressure on prices. Under such circumstances, prices are expected to remain weak.

In the financial markets, the overnight call rate has stayed at nearly zero, and confidence about the availability of liquidity is growing among many financial institutions. Interest rates on term instruments are declining further, reflecting the market's view that monetary easing will continue for some time. Moreover, the Japan premium has almost disappeared.

Long-term interest rates, on the whole, have declined against the background of no clear signs of economic recovery and the decline in term interest rates. Stock prices have been firm reacting to the further rise in U.S. stock prices since March.

The amount outstanding of funds in the call money market has been gradually decreasing. To date, this has not led to any difficulty in funds settlement, but close attention should be paid to future market developments.

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. As a result, credit demand in the private sector has weakened further.

Private banks have basically retained their cautious lending attitude. However, they are no longer constrained by severe fund-raising conditions and insufficient capital base. Under these circumstances, major banks have started to extend loans more actively than before, especially for projects involving relatively small credit risks, and their lending stance is gradually becoming positive.

As a result of these developments, credit conditions, which tightened previously, have eased somewhat.

The situation continues to warrant careful monitoring on the extent to which private banks will ease their lending stance, and how this change will affect firms' propensity to invest.