

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

Bank of Japan, Communication, 13 September 1999.

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The Bank's View²

Japan's economy has stopped deteriorating, and there are some activities improving such as exports and production. However, clear signs of a self-sustained recovery in private demand have not yet been observed.

With regard to final demand, business fixed investment has been on a downward trend. Recovery in private consumption continues to be weak on the whole. Housing investment, which had been recovering, has recently peaked out. Meanwhile, public works have been rising, and net exports (exports minus imports) have started growing due to an increase in exports.

Reflecting such developments in final demand and continued progress in inventory adjustment, industrial production is turning to an increase. Against this background, corporate and consumer sentiment has seen an improvement. The improvement in corporate sentiment, however, has not necessarily stimulated business activities, because firms strongly feel that they have excess capacity and employees and their profits remain weak. Meanwhile, the improvement in consumer sentiment is underpinning household expenditure even under the worsening employment and income conditions, but is not strong enough to push up overall private consumption.

As for the outlook, improvements in the overall financial environment partly due to the monetary easing by the Bank, along with a series of economic measures taken by the government, are expected to continue underpinning the economy. Moreover, the positive impact on domestic production of the recovery of overseas economies, especially of Asian economies, is likely to continue for some time. By contrast, leading indicators suggest a high probability of a moderate decrease in housing investment from this autumn. In addition, under cautious sales plans, firms are implementing further restructuring to improve their profitability. Although such corporate restructuring is expected to improve productivity, it is likely, in the short run, to reduce fixed investment and discourage household expenditure through the resulting deterioration in employment and income conditions. Moreover, it seems that the recent appreciation of the yen will have an adverse effect on corporate profits in the near term. 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 in order to assure the economy's sustained growth in the medium term.

With regard to prices, import prices have recently fallen slightly due to the appreciation of the yen, despite the rise in international commodity prices such as crude oil prices. Domestic wholesale prices are leveling off due to the progress in inventory adjustment as well as an increase in prices of some products closely related to international commodities, such as those of petroleum products. Consumer prices continue to be unchanged. Corporate service prices are still falling, although the pace of the decline is slowing. For a while, movements of overall prices are likely to be flat, as the decline in

¹ This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on 9 September 1999.

² The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on 9 September as the basis of monetary policy decisions.

domestic commodity prices has come to a halt reflecting the rise in import prices to date. However, substantial narrowing in the output gap led by a recovery in private demand is unlikely for the time being, and wages continue to decline. Thus, downward pressure on prices is expected to remain.

In the financial market, the overnight call rate has stayed at nearly zero and financial institutions have been confident about the availability of overnight funds. As for interest rates on term instruments, short-term rates such as those of three months have weakened. However, longer-term rates maturing beyond the year-end continue to be relatively high partly due to market participants' concern over the Year 2000 problem.

The Japan premium has continued to be nearly zero for short-term transactions.

Yields on long-term government bonds rose to 2 percent in late August, but have recently fallen to 1.8-1.9 percent. The yield spread between government bonds and private bonds (bank debentures and corporate bonds) has stopped narrowing.

Stock prices recovered the 18,000 yen level in late August, but subsequently declined against the background of the appreciation of the yen and the weak tone in US stock prices. Currently, the prices are around 17,500-18,000 yen.

The yen has appreciated further against the US dollar since mid-August to the current level of around 110 yen.

The amount outstanding of funds in the call money market has remained generally stable since the middle of June. 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, private banks have basically retained their cautious lending attitude. However, constraint that had been caused by severe fund-raising conditions and insufficient capital base has eased considerably. Under these circumstances, major banks have gradually become more active than before in extending loans, while carefully evaluating the credit risks involved.

However, credit demand for economic activities such as business fixed investment remains weak. In addition, some firms have recently been repaying their loans using their on-hand liquidity. As a result, credit demand in the private sector has continued to be weak, and thus private banks' lending has remained sluggish. Furthermore, the pace of issuance of corporate bonds and CP has generally been slowing.

Money stock (M_2 +CDs) has shown a year-to-year increase of about 4 percent partly due to an increase in fiscal expenditure.

In this financial environment, credit conditions have eased somewhat.

The following continue to warrant careful monitoring: how actively investors will take risks; how far private banks will ease their lending stance; and how these changes will affect economic activities.