

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

Bank of Japan, Communication 21 December 1999.

* * *

The Bank's View²

Japan's economy, which had stopped deteriorating, has recently started to improve, with exports and production increasing. The economic environment surrounding private demand is gradually improving, as seen in the continuing increase in corporate profits. However, clear signs of a self-sustained recovery in private demand have not been observed yet.

With regard to final demand, housing investment has recently peaked out, and public investment seems to have stopped rising. Recovery in private consumption continues to be weak through lack of notable improvements in employment and income conditions. Business fixed investment, which had been on a downward trend, shows signs of leveling off. Meanwhile, net exports (real exports minus real imports) continue to expand due to an upturn in overseas economies.

Reflecting such developments in final demand and continued progress in inventory adjustment, industrial production remains on an uptrend and an increase in corporate profits is becoming distinct. In this situation, corporate sentiment continues to improve. Regarding the employment condition, there are some indicators that suggest a slowdown of decrease in the number of employees. The positive developments in corporate profits and sentiment, however, have not necessarily stimulated business activities, because firms still strongly feel that they have excess capacity and employees and that they should reduce their debts to restore financial soundness. In addition, efforts by firms to reduce personnel expenses have prolonged the severity of households' income conditions.

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 and have favorable effects on corporate profits and then on household income. By contrast, it is highly probable that housing investment will remain flat for the time being. In addition, firms are expected to maintain a cautious stance toward business fixed investment based on their modest prospects for sales, although corporate restructuring is improving profitability to some extent. Moreover, it seems that the appreciation of the yen since the summer will have an adverse effect on corporate profits in the near term. In these circumstances, future economic developments still require careful monitoring in spite of the gradual recovery in the environment for private demand. Furthermore, it is important to promote structural reform in order to facilitate a recovery in private demand.

With regard to prices, import prices are declining somewhat due to the appreciation of the yen. Domestic wholesale prices, notwithstanding the fall in prices of electric machinery, are flat mainly due to the rise in prices of petroleum and chemical products reflecting an increase in crude oil prices. Consumer prices remain unchanged. Corporate service prices are still falling slowly. As for the outlook, overall prices are likely to be flat for the time being despite the continued fall expected in

1 This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on December 17, 1999.

2 The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on December 17 as the basis of monetary policy decisions.

prices of some machinery. This is because the supply-demand balance is improving gradually, as shown in the decline in inventories, and because the rise in crude oil prices to date will continue to be passed on to prices of other products for a while. However, attention should still be paid to the downward pressure on prices, as clear signs of a self-sustained recovery in private demand have not yet been observed and wages continue to fall.

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. The amount outstanding of funds in the call money market has increased slightly as transactions are becoming active with the year-end approaching.

As for interest rates on term instruments, rates maturing beyond the year-end rose until the beginning of December mainly due to the influence of the Year 2000 problem, but plunged subsequently as financial institutions made progress in securing year-end funds amid ample funds provision by the Bank of Japan.

The Japan premium has almost disappeared even for transactions maturing beyond the year-end.

Yields on long-term government bonds rose slightly to nearly 1.9 percent from the middle of to late November reflecting improved confidence in the economy, but then fell back due to the yen's appreciation and other factors, and are presently ranging between 1.70-1.75 percent. The yield spread between private bonds (bank debentures and corporate bonds) and government bonds continues narrowing, primarily that between private bonds with relatively low credit ratings and government bonds.

Stock prices, after rising in November against the background of improved confidence in the economy and firmness of U.S. stock prices, weakened slightly due to the strengthening of the yen and other factors, and are currently moving around 18,000-18,500 yen.

In the foreign exchange market, the yen appreciated further against the U.S. dollar in late November, and is recently been traded in the range of 102-104 yen.

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 are gradually becoming more active 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 been trying to reduce debts using their on-hand liquidity. As a result, credit demand in the private sector has continued to be basically stagnant, and thus private banks' lending has remained sluggish. Corporate bond issuance has been steady. Meanwhile, CP issuance is increasing with the year-end approaching.

The growth of money stock (M_2 +CDs) has slowed somewhat mainly due to the weakness in credit demand in the private sector.

In this financial environment, the financial position of firms is easing, and the lending attitude of financial institutions as perceived by firms is becoming less severe. It continues to warrant careful monitoring how these favorable developments in corporate financing environment will affect economic activities.