

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

Bank of Japan, Communication, 19 January 2000.

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

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 follow an upward trend, despite monthly fluctuations, due to an upturn in overseas economies.

Reflecting such developments in final demand and progress in inventory adjustment, industrial production continues to rise 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 of 1999 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 fundamentally. Corporate service prices are still falling slowly. As

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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 January 17, 2000.

<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 January 17 as the basis of monetary policy decisions.

for the outlook, overall prices are likely to be flat for the time being despite the continued fall expected in 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.

The financial markets have been generally stable reflecting ample funds provision by the Bank of Japan, despite the surge in demand for liquidity including seasonal demand for year-end funds and precautionary demand in view of the Year 2000 problem. No significant disruptions have resulted from the millennium date change in financial transactions.

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.

Interest rates on term instruments rose toward the end of 1999 due to market participants' concerns about the Year 2000 problem, but declined around the turn of the year as these concerns were dispelled. The Japan premium remains negligible.

Yields on long-term government bonds generally followed a downward trend from late November throughout December 1999, but then rebounded somewhat and are presently ranging between 1.75-1.80 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 exceeding 19,000 yen at the beginning of 2000, weakened to around 18,000-18,500 yen following the correction in the U.S. stock market. Subsequently, they recovered reacting to the rebound in U.S. stocks and have returned to the level of above 19,000 yen.

In the foreign exchange market, the yen once appreciated to the 101-102 yen level against the U.S. dollar at the beginning of the year, but then depreciated and is currently being traded in the range of 105-107 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, firms continue to reduce debts as part of their balance-sheet restructuring measures. As a result, credit demand in the private sector has continued to be basically stagnant, and thus private banks' lending has remained sluggish. Issuance of corporate bonds and CP has been steady at present.

The growth in money stock ( $M_2$ +CDs) has slowed somewhat reflecting the stagnant private credit demand.

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.