

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

Bank of Japan, Communication, 19 May 2000.

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The Bank's view²

The improvement in Japan's economy is becoming distinct. Recovery has been observed in some areas of private demand, with business fixed investment continuing to increase gradually.

With regard to exogenous demand, net exports (real exports minus real imports) continue to follow an upward trend due to steady developments in overseas economies, and public investment has started to pick up reflecting the progress in the implementation of the supplementary budget for fiscal 1999. As regards domestic private demand, housing investment is on a moderate declining trend, and recovery in private consumption continues to be weak through lack of notable improvements in employment and income conditions. Meanwhile, business fixed investment continues to increase gradually.

Reflecting such developments in final demand, industrial production is increasing, and corporate profits and sentiment continue to improve. Firms as a whole still strongly feel that they have excess capacity and employees, and that they should reduce their debts to restore financial soundness. Nevertheless, the number of firms that take positive action, such as increasing the amount of fixed investment, is increasing gradually, especially in high-growth sectors. Regarding employment conditions, although the decrease in the number of employees and in wages is slowing, efforts by firms to reduce personnel expenses have prolonged the severity of households' income conditions.

As for the outlook, public investment is likely to increase for some time. This, along with the favorable financial environment created partly by the Bank's monetary easing, is expected to continue underpinning the economy. Moreover, net exports are likely to follow an upward trend reflecting the recovery of overseas economies, and it is also highly probable that business fixed investment will increase gradually with an improvement in corporate profits and sentiment. However, housing investment is expected to continue declining moderately, and there seems to be no substantial change in firms' stance to reduce personnel expenses. Hence, it may take some time for households' income conditions to improve and, in turn, for private consumption to recover. In addition, since firms' prospects for sales remain modest, careful monitoring is still required to determine whether the recovery in business fixed investment is sustainable and whether it is likely to spread to a wider range of industries.

With regard to prices, the rise in import prices is slowing, reflecting a temporary decline in international commodity prices such as crude oil prices. Domestic wholesale prices, notwithstanding the fall in prices of electric machinery, are somewhat strong mainly due to the rise in prices of petroleum and chemical products reflecting the increase in crude oil prices to date. Meanwhile, consumer prices continue to be somewhat weak due to the slight decrease in the prices of private-sector services and the decline in prices of imported products reflecting the past appreciation of the yen. Corporate service prices are still falling slowly.

As for the outlook, upward pressure on prices is likely to arise from the gradual improvement in domestic supply-demand balance and from the rise in crude oil prices. On the other hand, downward

1 This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on 17 May 2000.

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

pressure is expected from the long-term declining trend of machinery prices due to technological innovations and from the fall in prices of imported products reflecting the past appreciation of the yen. On balance, overall prices are likely to remain unchanged. However, attention should still be paid to the downward pressure on prices stemming from weak demand, although the pressure has weakened given some recovery in private demand.

In the financial market, the overnight call rate has generally stayed near zero, and financial institutions have been confident about the availability of overnight funds. The amount outstanding of funds in the call money market has remained generally stable.

Interest rates on term instruments have weakened somewhat. The Japan premium remains negligible.

Yields on long-term government bonds once rose above 1.8 percent in mid-April but then declined and are recently moving in the range of 1.7-1.8 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 on the whole recovered from a plunge triggered by a drop in U.S. stocks although they showed divergent movements by index.

In the foreign exchange market, the yen strengthened slightly against the U.S. dollar in mid-April but generally weakened thereafter. The yen is currently being traded in the range of 108-110 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. Given this, major banks are becoming more active in extending loans, while carefully evaluating the credit risks involved.

On the other hand, the improvement in economic activities has not stimulated corporate demand for external funds, since firms' cash flow is increasing in parallel with a recovery in profits. Moreover, 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.

In view of this, the underlying tone of private banks' lending seems to remain sluggish although its year-on-year rate of decline slowed in April for the second consecutive month. Issuance of corporate bonds and CP has been steady.

Money stock (M_2 +CDs) grew faster in April compared with the previous month on a year-on-year basis.

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