

Bank of Japan's December review of monetary and economic trends in Japan
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A moderate economic recovery continues in Japan, as private demand shows increasing firmness. With respect to final demand, public sector investment has peaked, but housing investment has remained at a high level because of low interest rates. The decline in net exports has paused. Business fixed investment is increasing steadily and a moderate increase also continues in personal consumption. Meanwhile, inventories on the whole are at appropriate levels. In these circumstances, industrial production growth is somewhat accelerating and corporate sentiment is improving gradually. Labor market conditions have improved on the whole, although the unemployment rate has remained at a high level. Meanwhile, the decline in prices is slowing gradually and monetary aggregates continue to grow at 3.0 - 4.0 per cent.

With regard to personal consumption, growth in sales of electrical appliances has been high, particularly in personal computers and cellular phones, and passenger car sales (excluding compact cars) have recently increased significantly. Outlays for travel have remained firm and sales at department stores and supermarkets are increasing at a moderate pace.

Among leading indicators of business fixed investment, machinery orders are increasing steadily albeit with some quarterly fluctuations. After the decline in the third quarter 1996, they are expected to increase significantly in the fourth quarter. Construction floor area has also picked up moderately. According to the Bank of Japan's *Tankan -- Short-Term Economic Survey of Enterprises in Japan* of November 1996, business fixed investment plans of principal manufacturing firms for fiscal 1996 continued to increase at the same pace as those for fiscal 1995, while those of non-manufacturing firms turned to increase for the first time in five years. As a result, business fixed investment of principal firms overall is expected to expand at a faster pace than in fiscal 1995. Business fixed investment plans of small firms (all industries) were revised upwards substantially from the August Tankan, marginally exceeding the level of the previous year for the first time in five years. This shows that the recovery in business fixed investment is spreading across a wider spectrum of industries and corporate sizes.

With respect to housing investment, housing starts have continued to grow reflecting low interest rates and reasonable housing prices. It recorded a seasonally-adjusted annual rate of 1.82 million starts in October 1996, the highest level since November 1973, partly reflecting the increase in orders in September 1996 before the expected rise in the consumption tax.

Regarding public-sector investment, the volume of public works contracted has, since spring 1996, stayed virtually unchanged from the level of the previous year as orders included in the economic policy package of September 1995 subsided. Public works activities such as shipments of related goods increased until summer 1996, reflecting time lags between the order and actual implementation of public works. Recently, however, they have also peaked out.

Real exports have shown a moderate increase as the effects of the yen's depreciation since summer 1995 have gradually become apparent after a time lag. Meanwhile, real imports have continued to rise, in part supported by structural elements, e.g., the increased supply capacity of Asian economies. However, the tempo of increase has somewhat slowed, which also reflects the depreciation of the yen. Thus, both the real trade surplus and the nominal current account surplus declined rapidly until the first half of 1996 but have been rising since summer 1996.

Industrial production increased steadily in the third quarter 1996 by an annual rate of about 6 per cent and also rose significantly in October. These increases reflect the progress in inventory adjustments and the continued increase in shipments of capital goods, which is closely related to business fixed investment. They also reflect higher growth in domestic sales and exports of passenger cars which have a large influence on production activities. Industrial production is expected to increase by an annual rate of about 10 per cent in the fourth quarter 1996 on the whole.

The *Tankan* of November 1996 shows that the corporate profits of principal firms in both the manufacturing (excluding petroleum refining) and non-manufacturing sectors are forecast to continue increasing in fiscal 1996. Profit levels have risen particularly for manufacturing firms; the current profit-to-sales ratio is expected to reach over 4 per cent for the first time in five years. In these circumstances, business confidence of principal manufacturing firms improved moderately and is forecast to continue its upward trend. In the assembly industry in particular, the percentage differential between firms responding "favorable" and "unfavorable" has turned positive for the first time since February 1992. For non-manufacturing firms, business confidence has strengthened but it is forecast to weaken somewhat in the near future. On average, business confidence of non-manufacturing firms is on an upward trend. Small firms in both the manufacturing and non-manufacturing sectors are expected to show continuing growth in profits in fiscal 1996. However, while business confidence of manufacturing firms continues to improve moderately, that of non-manufacturing firms remains virtually unchanged partly as a result of uncertainties about the outlook for public-sector investment.

Labor market conditions have improved somewhat on the whole. Although the unemployment rate remains at a high level and employment growth is weak, overtime working hours have increased, and the ratio of job offers to job applications has continued its gradual rise.

With respect to price developments, domestic wholesale prices (adjusted for seasonal electricity rates) seem to have stopped declining although downward pressures from competition with imports remain strong. This development was supported by the yen's depreciation to date, the rise in crude oil prices and the improvement in domestic supply and demand conditions, particularly in construction-related goods. Corporate service prices have declined, particularly in rents and leasing charges, but the year-to-year decrease has become smaller. Consumer prices (nationwide, excluding perishables) have stayed slightly above the previous year's level as commodity prices have continued to fall gradually and service prices have risen somewhat.

Growth in monetary aggregates, measured in terms of the year-to-year growth rate of M2 +CDs average outstanding, has remained at 3.0 - 4.0 per cent, albeit with some fluctuations.

Regarding money market rates, the overnight call rate (uncollateralized) on the whole has stayed below the official discount rate of 0.5 per cent. The 3-month CD rate has moved at around 0.5 per cent. Meanwhile, with regard to the market's interest rate expectations, 3-month Euro-yen futures declined at a somewhat brisk pace between the second half of July and autumn 1996, and have moved at around 0.7 - 0.9 per cent since September 1996. As the market's expectations of higher interest rates receded, the long-term government bond yield has declined since mid-July 1996, and recorded a historical low of 2.34 per cent in early December. Recently, it has been moving at around 2.4 per cent.

With respect to bank lending rates, the short-term prime lending rate has remained at a record low level of 1.625 per cent since September 1995. The long-term prime lending rate was lowered by a total of 0.8 percentage points in September, October, and December to reach a record low of 2.5 per cent, reflecting developments in long-term market rates. In these circumstances, short-term and long-term average contracted interest rates on new loans and discounts have moved at record low levels.

On the stock exchange, the Nikkei 225 Stock Average had remained virtually unchanged since summer 1996 at around ¥20,000 - 21,000, varying across firms. Recently, however, it has weakened somewhat.

In the foreign exchange market, the yen's appreciation reversed its course and depreciated against the U.S. dollar between summer 1995 and autumn 1996. Since early 1996, the yen has continued to depreciate and has recently moved at around ¥114. Meanwhile, the yen depreciated temporarily against the deutsche mark in October and November 1996, and has recently moved at around ¥72 - 73.