

Bank of Japan presents its quarterly economic outlook for winter 1997

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1. A moderate economic recovery continues in Japan as private demand shows increasing firmness. Among final demand items, public-sector investment has begun to decrease while net exports have started to rise. Housing investment has remained at a high level and business fixed investment is also increasing steadily. While the increase in personal consumption has been moderate on the whole, passenger car sales have recently increased at a faster pace. Meanwhile, inventories are generally at appropriate levels. In these circumstances, industrial production is increasing and recently, in particular, the pace of growth has accelerated to some extent. Labor market conditions have continued to improve moderately.

Prices have stopped declining on the whole. Domestic wholesale prices (adjusted for seasonal electricity rates) have almost stopped declining, reflecting the depreciation of the yen and the rise in oil prices to date as well as the moderate improvement in domestic supply and demand conditions, particularly in construction goods. The year-to-year decline in corporate service prices is narrowing gradually. Consumer prices (nationwide, excluding perishables) are marginally above the previous year's level. Land prices continue to weaken on the whole, but there are some signs of improvement in the supply and demand conditions. On the balance of payments, the real trade surplus has recently started to increase and the nominal current account surplus is also rising moderately.

2. In the financial markets, the overnight call rate (uncollateralized) has stayed slightly below the official discount rate, and the 3-month CD rate has remained at 0.50 - 0.55 per cent since autumn 1996. The long-term government bond yield has been declining since July 1996, and it marked a record low of 2.3 - 2.4 per cent in early December and has recently remained at around 2.4 per cent. Stock prices have declined substantially since the end of 1996. The yen has been depreciating since the end of 1996, particularly against the U.S. dollar.

Meanwhile, growth in lending by private financial institutions has continued to be slow, owing both to weak corporate demand for new funds and to an increase in capital market financing. Monetary aggregates in terms of M2 + CDs average outstanding, however, have continued to grow at over 3.0 per cent.

3. To gauge future developments of Japan's economy in the context of individual components of final demand, public-sector investment is expected to show further declines in the coming months. Net exports are likely to continue to increase for some time despite the increase in imports caused by structural factors, as the effects of the yen's depreciation since 1995 manifest themselves.

As for the growth momentum of domestic private demand, corporate profits are increasing reflecting such factors as the depreciation of the yen and the rise in production. The recovery in corporate profits is gradually spreading to the whole corporate sector, including small firms. Reflecting conditions conducive to business fixed investment, such as the increase in corporate profits and progress in capital stock adjustments, business fixed investment on the whole is expected to continue a steady recovery for some time despite the influence of the slowdown in the market expansion in the mobile telecommunications industry. With respect to the household sector, housing investment is unlikely to show significant declines under the generally easy monetary conditions. Personal consumption on average is expected to continue its moderate recovery, reflecting the rise in household incomes and strong demand in areas such

as passenger cars and information-related products, although the consumption tax rate hike will exert some negative influences on consumption growth.

However, growth in business fixed investment is still checked as balance-sheet adjustment pressures remain strong. Also, the gains in household incomes are expected to be restrained to some extent as many firms still judge their work force to be excessive.

4. Turning to the outlook on prices, the deceleration in the declining tempo is expected to become more evident. Factors contributing to this include the rise in import prices to date owing to the effects of the yen's depreciation and the rise in crude oil prices, as well as an improvement in domestic supply and demand conditions. However, prices are unlikely to follow a clear upward trend for some time because of the modest pace of improvements in supply and demand conditions and the intense global competition, but the influence of the accelerated rise in import prices requires careful monitoring.

5. In sum, recovery in private demand shows increasing firmness with a strengthened virtuous cycle that involves production growth. Net exports, which had been exerting a downward pressure on the economy until the middle of 1996, are beginning to support income formation mainly reflecting the yen's depreciation to date. Considering that the restraining effects from fiscal policy on the economy are likely to strengthen, and that a setback in demand is expected following the surge in anticipation of the consumption tax rate hike, Japan's economic growth is expected to slow down temporarily in the first half of fiscal 1997. Judging from the above developments, however, the economic recovery on the whole will most likely continue in the future.

At the same time, there remain factors, such as balance-sheet adjustment pressures, which tend to keep private demand from gaining strength. Also, the influence of the recent plunge in stock prices on corporate sentiment requires careful scrutiny. In these circumstances, it is essential to promote necessary adjustments by such means as a swift implementation of effective reforms in Japan's economic structure. This is an important ingredient in the efforts to strengthen the basis for medium-term growth in Japan's economy.