

## **Bank of Japan presents its quarterly economic outlook for spring 1997**

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1. Japan's economy continues on a recovery trend despite some fluctuations caused by the rise in the consumption tax rate, with private demand showing underlying firmness. Among final demand items, public-sector investment has decreased, and housing investment has declined reflecting the reversal in the stepped-up demand which took place ahead of the rise in the consumption tax rate. However, net exports have continued on an increasing trend, and business fixed investment has been rising steadily. Personal consumption is on a moderate recovery trend. Meanwhile, inventories are generally at appropriate levels. In these circumstances, industrial production has been strengthening since autumn 1996. Labor market conditions have been improving moderately on the whole.

Prices have stopped declining. Domestic wholesale prices (adjusted for seasonal electricity rates) increased in early April 1997 reflecting the rise in the consumption tax rate. However, the downward pressures remain strong on those such as electrical machinery. Despite these pressures, domestic wholesale prices have remained unchanged or have increased marginally. This reflects the yen's depreciation and the higher oil prices to date, as well as the moderate improvement in domestic supply and demand conditions. The year-to-year declines in corporate service prices are narrowing, and consumer prices (nationwide, excluding perishables) are marginally above the previous year's level. With respect to commercial land prices, prices of large and well-located land suited for major developments have stopped declining, while those of land less suited for use have continued to decline. As for residential land, prices have gradually stopped declining. On the balance of payments, the real trade surplus has been on an increasing trend, and the nominal current-account surplus has also increased, albeit very moderately.

2. In the financial markets, the overnight call rate (uncollateralized) rose temporarily around the fiscal year-end, but has since declined to the level slightly below the official discount rate of 0.5 per cent. The 3-month CD rate has continued at around 0.50 - 0.55 per cent except for the fiscal year-end. The long-term government bond yield has been declining since summer 1996, and has recently moved at a low level of 2.1 - 2.2 per cent. Stock prices plummeted between the end of 1996 and the beginning of 1997, and have recently stayed at somewhat over ¥18,000. On the foreign exchange market, the yen has been depreciating against the U.S. dollar since mid-1995, and has recently moved at around ¥125 - 126.

Lending by private financial institutions has continued to be lackluster. Growth in monetary aggregates has continued at around 3.0 - 4.0 per cent, but it has declined somewhat compared to summer 1996.

3. Looking at individual components of final demand, public-sector investment is expected to follow a declining trend, although it may be supported for the time being by implementation of the government's supplementary budget for fiscal 1996. While both exports and imports will expand reflecting the progress in international division of labor, net exports are expected to continue increasing owing partly to the yen's depreciation since mid-1995.

With respect to the growth of domestic private demand, corporate profits of large manufacturing firms are improving steadily, helped partly by the positive effects on export prices and export volume stimulated by the yen's depreciation. Recovery in corporate profits has spread to nonmanufacturing firms which are closely related to business activities, as well as

to small manufacturing firms. Business fixed investment is thus expected to increase steadily in months ahead, mainly reflecting 1) this improvement in corporate profits, 2) the progress in capital stock adjustments, and 3) the rise in information-related investment. However, the pace of growth in business fixed investment is unlikely to accelerate significantly as balance-sheet adjustment pressures, for one, remain strong.

With respect to the household sector, growth in compensation of employees has been accelerating, mainly in bonus payments and overtime payments. Although the negative impact of the rise in the consumption tax rate is yet uncertain, consumer confidence will strengthen if growth continues to spread from the corporate sector to the household sector. Personal consumption will thus continue to recover, despite the reversal in the stepped-up demand that occurred prior to the rise in the consumption tax rate. Meanwhile, any drastic decline in housing investment is unlikely given present low interest rates, albeit with some reversal of the demand that peaked before the rise in the consumption tax rate.

4. Turning to the outlook on prices, there is potential upward pressure on prices reflecting the yen's depreciation, but they are expected to remain stable for some time. This is because, 1) crude oil prices have begun to weaken, 2) the recovery in domestic supply and demand conditions has been moderate, and 3) there remains a strong downward pressure on prices owing to technological innovations, particularly in electrical machinery. However, price differentials between home and abroad have narrowed, and the general sense of weak supply and demand conditions for products has receded. Thus, the Bank will monitor more closely future developments in domestic and overseas supply and demand conditions, as well as in the foreign exchange market.

5. In sum, private demand has firmed in a virtuous cycle as growth in production is accompanied by growth in incomes, supported partly by the yen's depreciation which augmented corporate profits and net exports. Thus, although economic growth will slow down temporarily in the first half of fiscal 1997 with the reversal in the stepped-up demand ahead of the rise in the consumption tax, chances are improving that economic recovery turns out to be sustainable. However, the extent of the negative effects caused by the rise in the consumption tax rate, including the reversal in the stepped-up demand, has yet to be confirmed. Also, balance-sheet adjustment pressures may continue to restrain the economic recovery. In these circumstances, promoting effective reforms of Japan's economic structure is an important ingredient in the efforts to strengthen the basis for recovery in private demand as well as the basis for a medium to long-term growth in Japan's economy.