

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

BANK OF JAPAN, QUARTERLY BULLETIN, August 1997 (advance summary).

1. Japan's economy continues on a moderate recovery trend. Production and income are showing underlying firmness despite the continued reaction to the temporary surge in demand ahead of the consumption tax hike. Among final demand items, public-sector investment has been on a decreasing trend, and housing investment has been somewhat lackluster, particularly as a result of the reaction to the rise in demand ahead of the consumption tax hike. On the other hand, net exports have recently increased significantly and business fixed investment has been rising steadily. Despite the continued decline in demand which followed the rise ahead of the consumption tax hike, particularly in consumer durables, the recovery trend in personal consumption does not seem to have been hindered. In these circumstances, industrial production has been firm and the growth in employees' income has been rising steadily, albeit moderately.

Price indices were pushed up in April 1997 by the consumption tax hike, but excluding this factor, prices have been stable. Both quarter-to-quarter and year-to-year changes in domestic wholesale prices (adjusted for seasonal electricity rates) have been near zero, and the year-to-year declines in corporate service prices have narrowed. The year-to-year rises in consumer prices (nationwide, excluding perishables) are widening somewhat, albeit by a small margin. Changes in commercial land prices have varied by type, and residential land prices have virtually stopped declining.

2. In the financial markets, the overnight call rate (uncollateralized) stayed slightly below the official discount rate of 0.5 per cent. The long-term government bond yield rebounded to near 2.7 per cent in late May, as market uncertainties about the economic outlook and the Japanese financial system gradually subsided after the second half of April. However, it declined to around 2.2 - 2.3 per cent. Stock prices rose to ¥20,000 - 21,000 in May and June 1997, and have recently been fluctuating without showing clear direction. In the foreign exchange market, the yen reached ¥127 to the U.S. dollar in early May, but later appreciated and has recently moved at around ¥113 - 116 to the U.S. dollar.

With respect to the fund-raising activities by firms, growth in bank lending continues to be lackluster but fund-raising through the capital market has been high, particularly in straight bonds. Growth in monetary aggregates in terms of M2 + CDs year-to-year average outstanding has continued at around 3.0 per cent.

3. Looking at individual components of final demand, public-sector investment will be supported by implementation of public works included in the government's supplementary budget for fiscal 1996 for the time being, but it is expected to follow a declining trend. Net exports, on the other hand, are likely to continue to be steady even after the recent large increase. This reflects the robust increase in overseas demand, and the recovery in the price competitiveness of Japan's manufacturing industry supported by the yen's depreciation until early spring.

In these circumstances, corporate profits on the whole are expected to continue improving in fiscal 1997 although with varied strength across sectors. Business fixed investment is also expected to continue increasing, mainly reflecting 1) increases in corporate profits, 2) further progress in capital stock adjustments, and 3) the rise in information-related investment. However, because of the remaining balance-sheet adjustment pressures and the

absence of leading industries, the increase in business fixed investment is unlikely to gather significant momentum for the time being.

The growth in the employees' income has been rising gradually owing to the increase in bonus payments and the moderate recovery in employment growth, reflecting the improvement in the labor market conditions. This shows that the recovery in the business sector has spread to the household sector. Thus, recovery in personal consumption is expected to continue after the reaction to the rise in demand ahead of the consumption tax hike subsides in the near future. However, the pace of recovery is likely to be moderate considering the increases in the tax burden, such as the rise in the consumption tax. Meanwhile, housing investment, which is in a generally favorable environment including low interest rates, is expected to recover somewhat in the second half of fiscal 1997, although it has recently been weak reflecting the reaction to the surge in demand ahead of the consumption tax hike.

4. With respect to price developments, the downward pressure on domestic prices from the increase in manufactured imports has weakened, as the rise in import penetration rate has paused. On the other hand, the upward pressure on import costs from materials prices has also subsided owing to the decline in crude oil prices since spring 1997 and the appreciation of the yen. Thus, import prices are not exerting significant upward nor downward pressure on domestic prices. Meanwhile, final demand will continue to recover on the whole, but the output gap is unlikely to narrow significantly as the pace of recovery in final demand is expected to be moderate. In these circumstances, prices are expected to be stable for some time.

5. In sum, the positive cycle among production, income and expenditure continues steadily and is reflected in the improvement in corporate profits and the rise in employees' income. Thus, despite the restraining pressures from fiscal policies, including the consumption tax hike and the decline in public-sector investment, Japan's economy is expected to continue its recovery, supported by the yen's depreciation until early spring and the expansion of information-related demand. However, the economic recovery is unlikely to gather significant momentum, as a result of fragility in some sectors, as well as the continued balance-sheet adjustment pressure. In these circumstances, building an economic environment which increases the confidence of the private sector is vital to strengthening the economic recovery. In this process, effective structural reforms to draw out the dynamism inherent in the economy continue to be essential in addition to appropriate macroeconomic policies.