

**Bank of Japan's summary of the annual review of monetary and economic developments in fiscal 1996** BANK OF JAPAN, ANNUAL REVIEW 1997.

Overview

Japan's economy followed a moderate recovery trend in fiscal 1996. The pace of recovery began to accelerate at the end of 1995, aided by substantially stimulative monetary and fiscal policy measures, and the recovery continued in fiscal 1996. In the second half of the fiscal year, the economic recovery firmed, particularly in private demand, driven in part by the depreciation of the yen since the previous year.

With respect to final demand in the first half of fiscal 1996, net exports declined sharply, reflecting such factors as the appreciation of the yen until the middle of 1995 and the increase in imports of manufactured goods from Japanese affiliates overseas. However, the economic recovery was underpinned by policy-related demand factors, such as the increase in public-sector investment reflecting the economic stimulus package of autumn 1995, and the high level of housing investment induced by low interest rates. In the middle of fiscal 1996, public-sector investment began to decline gradually from its peak, while net exports, which had been restraining the economic recovery, started to rise, partly reflecting the depreciation of the yen. Regarding private demand, business fixed investment increased steadily throughout the fiscal year, reflecting recovery in corporate profits, progress in stock adjustments, and a rise in autonomous investment, such as in information technology, and the increase spread across industries from large manufacturing firms to small nonmanufacturing firms. Personal consumption followed a moderate recovery trend in line with a recovery in compensation of employees despite fluctuations caused by factors such as the weather. From autumn 1996, automobile sales, which have a large influence on production, accelerated. Housing investment remained high, owing both to the increase in demand ahead of the rise in the consumption tax rate, implemented in April 1997, and to low interest rates.

Industrial production remained virtually unchanged until the middle of 1996, reflecting the decrease in net exports, and adjustments in the excessive inventories of some producer goods. However, growth in production has gradually gathered pace since the middle of the year, as private demand has increased steadily, net exports have begun to increase, and the increase in final demand has led more directly to a rise in production because of progress in inventory adjustments. At the end of the fiscal year, both industrial production and shipments recovered to the levels recorded at the previous peak in the economic cycle reflecting the increase in demand before the rise in the consumption tax rate. In these circumstances, corporate profits continued to recover primarily among large manufacturing firms, driven in part by a rise in profits of processing industries reflecting the depreciation of the yen and the success of corporate restructuring efforts. Business confidence also improved gradually, according to the Bank of Japan's "Tankan—Short-Term Economic Survey of Enterprises in Japan." The improvement in profits of large manufacturing firms was reflected in an increase in their expenditures, which in turn contributed to a recovery in the business conditions of corporate service industries and small manufacturing firms. As for labor market conditions, the unemployment rate remained high and growth in the number of the regularly employed stagnated owing to persistent adjustment pressures on personnel expenses in the corporate sector. However, overtime working hours and the number of new job offers increased steadily, reflecting production growth and improvements in corporate profits, and compensation of employees rose gradually, particularly in special cash earnings. In sum, the overall labor market conditions followed a recovery trend.

While substantially stimulative monetary and fiscal policy measures in fiscal 1995 continued to underpin economic recovery in early fiscal 1996, a positive cycle of demand, production, and income began to operate, underpinning the economic recovery throughout fiscal 1996. That is, an increase in final demand pushed up production and led to an improvement in corporate profits, particularly among large manufacturing firms. This in turn led to an improvement in profits and a rise in compensation of employees among nonmanufacturing firms and small firms, thereby expanding expenditures. During the second half of fiscal 1996, the recovery in private demand firmed, reflecting the positive effects of the depreciation of the yen on corporate profits, despite a decrease in public-sector investment. In other words, although the pace of the economic recovery remained moderate, a recovery led by policy demand is gradually shifting toward one led by private demand.

Although Japan's economy bottomed out at the end of 1993, the pace of recovery remains relatively moderate, owing to various structural adjustment pressures on industries. These include (1) pressures for the industrial structure to change in response to global competition resulting from the expansion of supply capacity in Asian countries, and to the constant appreciation of the yen until the middle of 1995; and (2) balance-sheet adjustment pressures owing to the sharp and significant decline in asset prices since the bursting of the economic "bubble" in the late 1980s. Steady progress has been made in dealing with the pressures for the industrial structure to change, as reflected in (1) a significant improvement in corporate profits, particularly among large manufacturing firms, resulting from the successful restructuring efforts and the depreciation of the yen from the middle of 1995; (2) progress in the reorganization of the international production system as seen in the shift in Japan's exports and production toward more capital- and technology-intensive goods; and (3) increased business fixed investment in new sectors owing to technological innovations and deregulation in information and communications industries. With regard to balance-sheet adjustments, strong adjustment pressures remained throughout fiscal 1996, as seen in the persistently high level of the ratio of debts to assets, especially among small nonmanufacturing firms.

In fiscal 1996, weakening of prices came to a halt. Domestic wholesale prices followed a downward trend until the middle of 1996, but in the second half of fiscal 1996 they virtually stopped declining, owing to a moderate improvement in domestic supply and demand conditions, as well as a rise in import prices reflecting the depreciation of the yen and the rise in crude oil prices. In March 1997, the year-to-year change shifted from decline to increase. Although corporate service prices continued to decline compared to the level of the previous year, reflecting the decrease in leasing prices and real estate rents, the year-to-year declines were smaller in the second half of fiscal 1996, due to a recovery in demand for services following the improvement in corporate profits. Consumer prices (nationwide, excluding perishables) also increased by a slightly wider margin from the previous year owing to a smaller decline in commodity prices as a result of the depreciation of the yen, and the halt in the decline in domestic wholesale prices, as well as a gradual increase in service prices. While prices seemed to have stopped declining, the increase in import prices from the depreciation of the yen and higher crude oil prices had little impact on domestic prices, as there remained persistent downward pressures on prices from imports of manufactured goods, particularly final goods, and technological innovations. As for commercial land, prices for large and well-located plots of land suitable for development virtually stopped declining owing mainly to the gradual progress in stock adjustment for office space. However, the prices of smaller plots of land with limited commercial value continued to decline. The recent development in commercial land prices thus indicates a distinct splitting into two groups. Meanwhile, residential land prices are bottoming out, reflecting the high level of residential housing construction.

The cyclical momentum for economic recovery gathered strength in fiscal 1996. However, the pace of the recovery remained moderate owing to continued structural adjustment pressures, including the balance-sheet problems. Although weakening of prices had come to a halt by the second half of fiscal 1996, prices were unlikely to follow an upward trend. Against the background of these economic and price conditions, the Bank of Japan maintained an easy monetary policy, keeping the official discount rate at its September 1995 level of 0.5 percent to establish a solid foundation for the economic recovery.

As for financial developments, the overnight call rate (uncollateralized) remained on average slightly below the official discount rate following monetary adjustments by the Bank of Japan. Long-term interest rates continued to rise with some fluctuations in the first half of 1996, but fell sharply in the second half. Interest rates on short-term instruments, namely 3-month certificate of deposit (CD) rates, followed a similar trend, although with smaller fluctuations than those in long-term interest rates. Stock prices continued to rise during the first half of 1996, but began to weaken in the summer, and fell sharply from the end of the year. The year-to-year growth rate of M2+CDs, a representative indicator of monetary aggregates, generally remained around 3.0-4.0 percent, but declined slightly in the second half of the fiscal year, partly due to the slow growth in funding in the private sector.

Despite the firm recovery of the real economy, particularly in the private sector during the second half of fiscal 1996, the financial markets during this period adopted a more cautious stance. This was because (1) the financial markets reacted in anticipation of the fiscal tightening measures—such as the rise in the consumption tax rate and the termination of special tax reductions in fiscal 1997—and this had restraining effects on economic conditions; and (2) there was renewed awareness that various adjustment pressures, especially balance-sheet adjustment pressures, remained strong among small nonmanufacturing firms and financial institutions. Under these circumstances, the cyclical developments of the economic recovery were not immediately reflected in financial indicators through the confidence of market participants. Meanwhile, significant progress was made in fiscal 1996 in the solution of the *jusen* (housing loan companies) problem, and steady progress was also made in solving the problem of nonperforming assets of financial institutions, including improvements in the framework for the resolution of failed financial institutions.

With respect to the outlook, the probability that Japan's economy will continue to recover is rising, although the pace of recovery may decelerate temporarily. This expectation is based on the fact that the positive cycle of production and consumption has not been deterred by the reaction to the increase in demand ahead of the consumption tax rate rise. Despite the continued economic recovery, the private sector has not gained sufficient confidence in its future growth, reflecting persistent uncertainty about structural adjustments. Under the structural adjustment pressures, expected growth rates are unlikely to rise at the same pace in different industries and firms. However, from a long-term perspective, the establishment of a new industrial structure based on the principle of comparative advantage can be expected to enhance growth by promoting the efficiency of resource allocation.

In order for Japan's economy to achieve sustainable growth, it is vital to create investment opportunities and raise expected growth rates of economic entities through effective reforms of the economic structure. Such efforts are essential in adapting to the medium- to long-term changes in economic environment, including increasing global competitive pressures, and the further aging of the population, and in maintaining Japan's economic strength. Considering the important role that the financial sector must play in the reforms of the economic structure, it will be necessary to continue implementing measures to stabilize the

Japanese financial system, and increase domestic and overseas confidence in the system. At the same time, the financial system must be reorganized to enhance its functions and competitiveness, by improving the infrastructure in order to promote competition in accordance with the Japanese “Big Bang” deregulation package.