

Bank of Japan presents its quarterly economic outlook for autumn 1997 BANK OF JAPAN, QUARTERLY BULLETIN, November 1997 (advance issue).

Summary

1. Japan's economic growth has been decelerating since April, partly reflecting the impact of the consumption tax hike. Corporate sentiment has also weakened somewhat. However, the recovery trend in corporate profits, employment and income conditions has not been undermined, supported by the rise in exports and business fixed investment.

Among final demand items, public-sector investment has been declining, and housing investment has also dropped significantly, mainly reflecting the decline after the surge in demand prior to the consumption tax hike. Personal consumption has continued to be sluggish on the whole, although the impact of the consumption tax hike has gradually subsided. However, net exports and business fixed investment have been increasing. In these circumstances, excessive inventories are seen in some industries such as in consumer durables, and industrial production has stayed virtually unchanged. Employment and income conditions have continued to improve, although the pace of recovery has moderated somewhat.

Prices remained stable on the whole, excluding the effect of the consumption tax hike. Domestic wholesale prices (adjusted for seasonal electricity rates) have been relatively weak, reflecting easy supply and demand conditions for construction-related goods. The year-to-year decline in corporate service prices has slowed steadily, and the year-to-year growth in consumer prices (nationwide, excluding perishables) has been stable at around 0.5-0.6 per cent. Meanwhile, changes in land prices varied by type, and have not stopped declining on the whole.

2. In the financial markets, the overnight call rate (uncollateralized) stayed at the level slightly below the official discount rate of 0.5 per cent. The long-term government bond yield temporarily rose to near 2.7 per cent at the end of May, but it followed a declining trend since then, reflecting the uncertainty about future economic growth. It has been moving at around the record low level of around 1.7 per cent since early October. Stock prices also moved at a low level of around 17,000 - 18,000. Meanwhile, the yen depreciated somewhat against the U.S. dollar as the contrast between Japan's and U.S. economic growth gained more attention. The yen has recently moved at around 120 - 122 to the U.S. dollar.

Growth in bank lending continues to be lackluster. Fund-raising activities through capital markets fell below the previous year's level. Growth in monetary aggregates in terms of M2 + CDs year-to-year average outstanding has continued at around 3 per cent.

3. With respect to the outlook, public-sector investment is expected to continue declining, judging from the government's budget. On the other hand, net exports are expected to follow an increasing trend, reflecting firm overseas demand and the depreciation of the yen to date, although the pace of increase will be slower than that recorded up to the second quarter.

According to the Bank of Japan's Tankan -- Short-Term Economic Survey of Enterprises of September 1997, the increase in corporate profits overall is expected to be maintained, albeit at a slower pace. While profits of small non-manufacturing firms are expected to decline owing to the decline in demand in addition to structural factors, those of large manufacturing firms are projected to continue on an increasing trend, largely supported by exports. In these circumstances, the pace of increase in business fixed investment may slow down somewhat as investment in telecommunications is expected to remain unchanged after surging in the previous fiscal year. However, given that stock accumulation is not excessive and demand for information-related investment is strong, business fixed investment will continue a steady increase.

As for the household sector, the growth in bonus payments and overtime payments has been slowing. This may suggest that the economic deceleration since spring 1997 has started to affect household income. However, the significant deterioration of household confidence is unlikely to be triggered by these developments, as the current employment conditions are very different from those of around 1993 when the risk of severe employment adjustment was large. Also, the recent weaknesses in personal consumption and housing investment partly reflect the temporary factors, such as the reaction to the front-loading of demand before the consumption tax hike. The downward pressure from fiscal policies is likely to weaken gradually in the near future. Therefore, once the impact of the consumption tax hike subsides, an early recovery of household expenditure may translate into the positive cycle of production, income and expenditure. Still, there are uncertainties about the recovery in personal consumption, as consumer confidence is susceptible to psychological elements.

4. With respect to price developments, domestic wholesale prices are likely to continue to be weak for the time being. This is because inventory adjustment pressures are being exerted, and the downward pressure from electrical goods prices caused by technological innovation remains strong, although the downward pressure coming from import prices has been subsiding. Meanwhile, corporate service prices will stay virtually unchanged, and consumer prices are likely to continue a similar moderate rise.

5. In sum, fiscal policies, including the consumption tax hike, continue to affect Japan's economy, and the slowdown in domestic demand seems to have influenced corporate profits, employment and income conditions gradually through a deceleration in production activity.

However, corporate profits and employees' income have maintained their growth, although at a somewhat slower pace. Also, labor adjustment and capital stock adjustment pressures are not so large, and the risk of deflation is negligible. In light of this, the basis for economic recovery has not been undermined. If household expenditure picks up and inventory adjustment pressures subside steadily, the economic recovery is likely to gather momentum again, albeit gradually. Given the cautious corporate sentiments and the uncertainty about future developments in demand, it is essential to monitor closely future economic developments, particularly the pace of recovery in household expenditure, and the progress in inventory adjustment.