

**Bank of Japan's December review of monetary and economic trends in Japan** BANK OF JAPAN, COMMUNICATION, 22/12/97.

Japan's economic growth has stalled. Weak household expenditures have gradually affected production, employment and income. Corporate sentiment is also deteriorating.

With respect to final demand, net exports have continued to increase and business fixed investment has been rising moderately, particularly in the manufacturing sector. Meanwhile, public-sector investment has been decreasing, and housing investment has also continued to be weak. Personal consumption has continued to stagnate, reflecting weakening consumer confidence. Industrial production has been on a slightly declining trend because inventory adjustment pressure has spread gradually reflecting weak final demand. The pace of improvement in employment and income conditions has been slowing. Prices have remained stable on the whole, with the exception of wholesale prices which have declined somewhat. Monetary aggregates continue to grow at around 3 per cent.

Personal consumption has continued to stagnate. Although outlays for travel have been increasing moderately, passenger car sales have fallen significantly below the level recorded in the second half of fiscal 1996 when sales surged, and have not even recovered the levels recorded before then. The recovery in sales of household electrical appliances has paused and sales at department stores and supermarkets have remained below the previous year's level.

Among leading indicators of business fixed investment, machinery orders continued to increase since early 1997 after having surged in the second half of 1996. Recently, orders from nonmanufacturing firms have been weak, however. Construction floor area has followed a moderate recovery trend, albeit with some fluctuations. According to the Bank of Japan's *Tankan* -- Short-term Economic Survey of Enterprises of December, investment growth in the principal nonmanufacturing firms for fiscal 1997 is projected to be lower than that in fiscal 1996, while growth in the principal manufacturing firms is planned to be higher than that in the previous fiscal year. This makes the growth of investment plans in principal firms overall the same as the previous year. Meanwhile, overall investment plans by small firms in fiscal 1997 are lower than those for fiscal 1996. This is because investment plans of nonmanufacturing firms fell significantly below the previous year, although plans of manufacturing firms at this time of the fiscal year grew at a somewhat higher pace compared to fiscal 1996.

With respect to housing investment, housing starts in terms of the seasonally-adjusted annual rate declined in July to 1.24 million, the lowest level since September 1985, following the surge in demand in the second half of 1996 ahead of the consumption tax hike. Housing starts have since remained weak at around 1.3 - 1.4 million.

Regarding public-sector investment, the amount of public works contracted has followed a decreasing trend reflecting the restrained budget for fiscal 1997.

Real exports have continued to rise since the second quarter 1997 against the background of steady overseas demand and the yen's depreciation to date. Real imports, on the other hand, have remained virtually unchanged, partly owing to weak domestic demand. Meanwhile, the impact of the turmoil in the East Asian economies has been limited, although some exports to Asia have declined. As a result, the real trade surplus has been increasing with

some fluctuations. Reflecting these developments, the nominal current-account surplus has also been expanding significantly since April 1997.

Industrial production remained virtually unchanged in the third quarter 1997. Production in the fourth quarter is expected to decrease on the whole. This is because inventory adjustment which has derived from weak domestic sales, began to spread from consumer durables and construction-related goods to materials.

Meanwhile, the December *Tankan* shows that the increasing trend in current profits is expected to continue for the large manufacturing firms (excluding petroleum refinery) in fiscal 1997, while those in the nonmanufacturing sector (excluding electricity and gas) are projected to decline. Forecasts of current profit growth in both the manufacturing and nonmanufacturing sector have been revised downwards since the September survey. In these circumstances, the business confidence DI for current conditions and on the outlook for principal firms in the manufacturing and nonmanufacturing sectors have both deteriorated. Current profits of small firms in both the manufacturing and nonmanufacturing sector are expected to decline in fiscal 1997. The business confidence DI has also deteriorated in most industries.

With respect to labor market conditions, the unemployment rate has remained at a high level, and the ratio of job offers to job applications has recently eased. In October 1997, overtime working hours fell below the previous year's level for the first time since August 1994, and the growth in employment and nominal wages has recently been slowing gradually, reflecting weak production. Thus, the pace of recovery in employment and income conditions has slowed.

Prices remained stable on the whole. Domestic wholesale prices have declined to some extent, partly owing to inventory adjustments. The corporate service prices on the whole have remained virtually unchanged from the previous year's level. This is because supply and demand conditions in real estate rents and information service prices have improved, although leasing charges have continued to decline. Consumer prices (nationwide, excluding perishables) have remained stable at a level slightly above that of the previous year excluding the institutional factors, such as the medical insurance system reform.

The growth in monetary aggregates, measured in terms of year-to-year growth of M2 + CDs average outstanding, was 2.9 per cent in October and 3.2 in November.

Regarding money market rates, the overnight call rate (uncollateralized) had moved at a level slightly below the official discount rate, and the 3-month CD rate had stayed at around 0.50 - 0.60 per cent since summer 1997. However, as the market participants became cautious following the failures of some financial institutions in November, the overnight call rate (uncollateralized) rose to around 0.65 in late November, and the 3-month CD rate to around 0.85 per cent in early December. In reaction to this, the Bank continued to provide the market with ample liquidity. As a result, the overnight call rate has gradually recovered its stability. Longer term money market rates, on the other hand, have remained high, partly reflecting the Japan premium in overseas markets. The long-term government bond yield fluctuated at around 1.6 - 1.8 per cent during November against the background of uncertainties about future economic growth and anticipation of the economic stimulus package. In early December, it reached the record low level of 1.5 - 1.6 per cent, and has recently recovered to 1.6 - 1.8 per cent.

With respect to bank lending rates, the short-term prime lending rate has remained at a record low level of 1.625 per cent since September 1995. The long-term prime lending rate has been at a record low of 2.3 per cent since October 1997. In these circumstances, short and long-term contracted interest rates for new loans and discounts (up to October) have stayed at record low levels. According to the December *Tankan*, both principal and small firms started to feel that the lending attitude of financial institutions have become more severe. Among small firms in particular, the difference between the total number of those which feel that the lending attitude is easy and those which feel that it is severe (easy minus severe) has reached a negative figure.

Against the background of uncertainties about economic growth and about the stability of the financial system, the Nikkei 225 stock average has declined to ¥15,000 by mid-November, with the additional impact from the precipitous decline in Hong Kong stock prices in late October. It has since shown wide fluctuations between ¥15, 000 and ¥17,000.

In the foreign exchange market, the yen had moved at around ¥119 - 123 to the U.S. dollar until October. However, the yen began to depreciate in November and temporarily declined to ¥131- 132 in mid-December. It then recovered and has recently moved at around ¥127 - 130. Meanwhile, the yen started to depreciate against the Deutsche Mark after having peaked at around ¥62 in mid-August, and has recently moved at around ¥71 - 74.