The Bank of Japan's January report of recent economic and financial developments BANK OF JAPAN, COMMUNICATION, 6/2/98.

Summary

Japan's economic growth remains stagnant. Sluggish domestic demand, especially household expenditures, has been exerting negative influence upon production, employment and income. Corporate sentiment has also weakened.

With respect to final demand, net exports have continued to increase, and business investment has been rising moderately, mainly in the manufacturing sector. Meanwhile, private consumption has continued to stagnate, reflecting cautious household sentiment that has persisted even after the rebound of the front-loading expansion of spending prior to the consumption tax hike had subsided. Housing investment has continued to be weak and public-sector investment has been decreasing. Reflecting the weak final demand, inventory adjustment pressures have been spreading, and industrial production has been on a slightly declining trend. The pace of improvement in employment and income conditions has also been slowing. Thus, the positive growth cycle of production, income, and expenditures has stalled.

As regards the outlook of the economy, external demand is expected to continue upholding the economic growth, and the special tax-cut measures announced in December 1997 are expected to have positive effects on household spending. Overall, however, the economy is likely to remain stagnant for a while, due to the intensifying pressures of inventory adjustment, the continued decline in public-sector investment, and the anticipated deceleration in business fixed investment. Given the slowdown in the pace of growth, the economy is considered to be vulnerable to further negative impacts. In these circumstances, the possibility of the emergence of further downside risks should be carefully observed, such as prolonged and intensified adjustments in the Asian economies, more restrictive lending stance of financial institutions impeding corporate finance, or further deterioration of confidence in the corporate and household sectors.

With regard to prices, wholesale prices have declined reflecting a slack in the supply and demand conditions of goods. Meanwhile, consumer prices have remained at a level slightly above that of the previous year when observed excluding the effects of institutional changes such as the rise in the consumption tax rate. Thus, prices on the whole remained stable. Prices are likely to be steady in the immediate future, since downward pressures on prices are not as significant as was the case in 1995, when the yen's appreciation induced a penetration of imports, which then directly dampened prices of import-competing domestic final goods, arousing concerns for a deflationary spiral in the economy. However, conditions which may affect price developments, including the slack in supply and demand conditions in the Asian economies, should be carefully examined, since the output gap in the domestic economy is unlikely to diminish for a while.

Financial markets have shown the following developments. Yields on TBs and long-term government bonds have been at around their lowest levels. Interest rates of term instruments in money markets and yields on corporate bonds and bank debentures, on the other hand, have risen and remained high due to the more cautious attitude of market participants toward credit and liquidity risks following the failure of some financial institutions. Stock prices have been low as the confidence in corporate profit growth continued to be weak and uncertainty over the financial system mounted. In the foreign exchange markets, the yen appreciated against the Asian currencies, while it depreciated against the US dollar.

With respect to growth in monetary aggregates, the underlying trend of lendings by private financial institutions has remained almost unchanged, and the year-to-year changes in average outstanding of M2+CDs have continued to be at around 3 percent. Lending attitudes of fnancial institutions, however, are becoming increasingly cautious as capital adequacy constraints have become more binding due to the fall in stock prices and the yen. Moreover, higher market interest rates are gradually pressuring lending rates to rise since December 1997. There is, therefore, a need to carefully monitor the developments in the financial markets and their influences on the real economy.