

Bank of Japan's August report of recent economic and financial developments

Bank of Japan communication, XX/8/98.

The Bank's View¹

Japan's economic conditions continue to deteriorate.

With respect to final demand, public investment seems to have bottomed out. Net exports have resumed to increase mainly due to a decline in imports. However, business fixed investment has been decreasing significantly, and housing investment has weakened further. Private consumption has not yet shown a resumption. Against this background of weak final demand, substantial production cutbacks continue. As a result, inventories have decreased somewhat, but the level is still high. With the decline in expenditure and production, corporate profits continue to decrease, and employee income remains below the previous year's level. In addition, the ratio of job offers to applications has dropped to a historically low level, and the unemployment rate has increased further. As a whole, employment and income conditions have worsened.

Although the above indicates a continued negative interactions of production, income, and expenditure, a further deterioration in the economy is expected to cease gradually from the effects of the comprehensive economic stimulus package including additional public works and the special income tax reduction. Given the current considerably low level of economic activities, however, the positive influence of the package on private demand will likely be limited, and the economy's immediate transition to a self-sustained recovery is hardly expected. In these circumstances, the relevant bills have been submitted to the Diet to rebuild the stability of the financial system. Moreover, the new administration is planning to launch new economic stimulus measures, including additional public investment in the supplementary budget for fiscal 1998 and the reduction in personal income taxes and corporate taxes. The materialization of these policies along with their effects on corporate and household sentiment should be carefully monitored.

With regard to prices, wholesale prices are on a downtrend, and consumer prices (excluding the effects of institutional changes²) remain below the previous year's level. With respect to the factors affecting the outlook, the downward pressure on domestic prices induced by the decline in import prices is weakening. In addition, the expansion in the output gap in the economy is expected to slow in line with the implementation of the comprehensive economic stimulus package. Nevertheless, reflecting the present large output gap, the downward pressure from domestic factors is unlikely to weaken considerably, and hence, prices are likely to be weak for some time.

As for financial markets, yields on long-term government bonds and stock prices rose toward mid-July 1998 reflecting growing anticipation for permanent tax cut. However, they have declined since then as a wait-and-see posture has prevailed among market participants with the growing attention to the concrete measures of the new administration's economic policies. Meanwhile, Euro-yen interest rates and the Japan premium indicate strong market concerns regarding credit risks of financial institutions and liquidity risks at end-September 1998, the end of the first half of fiscal 1998.

With respect to monetary aggregates, growth in M_2 +CDs has been slowing, reflecting the sluggish private bank lending. These developments basically reflect the further decline in the credit demand of private firms with the worsening of overall economic activities, along with the continued cautious lending stance of private banks.

¹ The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on August 11, as the basis of monetary policy decisions.

² The rise in medical service charges due to the medical insurance system reform of September 1997.

Meanwhile, some firms, especially small and medium-sized firms, have been facing difficult financing conditions in terms of both funds availability and fund-raising costs. This influence on the overall economy continues to warrant careful monitoring.