

## **Bank of Japan's monthly report of recent economic and financial developments**<sup>1</sup>

BANK OF JAPAN, COMMUNICATION, October 1998.

### The Bank's View<sup>2</sup>

Japan's economic conditions still continue to deteriorate.

With respect to final demand, public investment has bottomed out. Net exports (exports minus imports) are basically increasing mainly due to a decline in imports. Business fixed investment, however, has been decreasing significantly partly because of financial constraints, and housing investment has declined further. Private consumption has not yet shown a recovery despite the special income tax reduction. Against this background of weak final demand, production has been reduced substantially. As a result, some industries have shown improvements in inventory adjustments, but the level of inventories is still high as a whole. With the decline in expenditure and production, corporate profits are worsening rapidly. Furthermore, the employment and income conditions have deteriorated further as the unemployment rate marked a historical high and the decline in employee income has accelerated. In these circumstances, corporate perceptions of business conditions have worsened substantially and consumer sentiment has become cautious.

As the above indicates, there remain continued negative interactions of production, income, and expenditure. With the effects of the comprehensive economic stimulus package and the recent monetary easing, the deterioration of the economy is expected to moderate gradually toward the second half of fiscal 1998. Nevertheless, the economy is hardly expected to recover immediately, judged from the strong negative interactions mentioned above and the financial constraints such as financial institutions' cautious lending stance due to the nonperforming-loan problem. In these circumstances, there is an immediate need to rebuild the stability of the financial system. In this regard, bills related to financial revitalization have been legislated, and a bill related to bank recapitalization, including policy measures to strengthen banks' capital base through injecting public funds, has passed the House of Representatives of the Diet. It is desirable that functions of and confidence in Japan's financial system be restored based on these schemes. Furthermore, the government is devising plans for economic recovery, including reduction in personal income taxes and corporate taxes as well as additional public investment. It is important to materialize these measures promptly, in such a way that they not only have sizable direct effects on the economy but also contribute to restore corporate and household confidence.

With regard to prices, wholesale prices are on a downtrend reflecting the expanding output gap, and consumer prices have fallen below the previous year's level. With respect to the outlook, given the persistently strong negative interactions of production, income, and expenditure, the expansion in the output gap seems unlikely to cease despite the expected effects of the comprehensive economic stimulus package. Furthermore, the continued decline in wages and the recent appreciation of the yen may exert downward pressure on prices. Hence, prices are likely to be on a downtrend for some time.

In the financial markets, responding to the further monetary easing by the Bank of Japan on September 9, short-term interest rates declined as a whole after mid-September. However, since the end of September, the Japan premium has expanded and interest rates on Euro-yen deposits

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<sup>1</sup> This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on October 13, 1998.

<sup>2</sup> The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on October 13, as the basis of monetary policy decisions.

have rebounded slightly reflecting intensified market concern toward Japanese financial institutions' funding in foreign currencies over the year-end. In the meantime, due to heightened uncertainty over the economic outlook, long-term interest rates declined considerably.

Stock prices continued a downtrend reflecting the concern over the worldwide stock market plunge, the further deterioration in economic indicators, and the persistent uncertainty over the resolution of the problems with Japan's financial system. In October, stock prices recorded historically low levels since the bursting of the economic "bubble". Meanwhile, in early October, the yen surged against the dollar with the emerged uncertainty over the outlook of the US economy.

With regard to corporate finance, while funding needs for real economic activities seem to be decreasing, some firms, especially large ones, are seeking to secure ample on-hand liquidity to prepare for unexpected situations. Reflecting such increase in credit demand, the growth rate in  $M_2+CD$  has slightly recovered since the summer of 1998.

However, Japanese financial institutions have become more cautious in extending loans, facing up severe fund-raising environments and deteriorating business conditions of borrower companies. While especially large firms are steadily increasing the issuance of commercial paper and corporate bonds, small and medium-sized firms and relatively low-rated ones continue to face difficult conditions for fund-raising in capital markets. The influence of these severe financial conditions on business activities and on the economy continues to warrant careful monitoring.