Bank of Japan's monthly report of recent economic and financial developments[1]

Bank of Japan, Communication, 17/12/98.

The Bank's View[2]

The economic deterioration in Japan has moderated somewhat, mainly as a result of the increase in public investment.

With respect to final demand, business fixed investment has been declining significantly, and housing investment continues to be sluggish. Private consumption, as a whole, shows some weakness. Meanwhile, net exports (exports minus imports) are basically on an upward trend, and public investment has started to increase considerably. Reflecting this development of final demand and some progress in inventory adjustments, especially in those of durable goods, the decline in production has been slowing.

Corporate profits continue to worsen, and employment and household income conditions have deteriorated as the ratio of job offers to applications has recorded a historical low and winter bonuses are expected to decrease. Financial conditions are improving in some firms with the effects of the policy measures taken by the government and the Bank. Nonetheless, firms apparently cannot remove their anxiety about fund-raising conditions. Consequently, corporate and household sentiment remains cautious, and a recovery has not been observed in private demand.

With the implementation of the government's comprehensive economic stimulus package and recently launched emergency economic measures, the economy is likely to be underpinned mainly by public investment towards [= during?]the first half of fiscal 1999. Furthermore, the Bank's monetary and financial measures and the government's measures to alleviate the credit crunch are expected to take effect gradually. Nevertheless, an immediate self-sustained recovery in private demand is hardly expected since corporate profits and household income are deteriorating and the constraints from corporate finance are likely to persist for some time, owing to cautious lending attitudes of private banks. Moreover, attention should be paid to the effects of the appreciation of the yen since early autumn and the uncertainty in financial and economic developments abroad. To lead Japan's economy into a steady recovery, it is important to prepare an environment where firms and households can regain confidence in Japan's economic future by, for instance, promptly restoring the stability of the financial system.

With regard to prices, reflecting the expansion in the output gap, wholesale prices are on a downtrend, and corporate service prices are weakening. Consumer prices have increased slightly above the previous year's level, owing to the rise in prices of perishables. Excluding this effect, however, consumer prices basically continue to be weak. As for the outlook, the economic deterioration is likely to moderate, mainly as a result of the increase in public investment. Nonetheless, distinct narrowing in the output gap is hardly expected for the time being as private demand remains sluggish. Furthermore, the continued decline in wages and the appreciation of the yen since early autumn are likely to exert downward pressure on prices. Hence, the decline in prices, especially in wholesale prices, may somewhat accelerate in the future.

[1] This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on December 15, 1998.
[2] The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on December 15, as the basis of monetary policy decisions.

Turning to the financial markets, Japanese banks are successfully raising foreign currency funds necessary to cover a huge shortage at the year-end. Reflecting this, the Japan premium and Euro-yen rates have peaked out, and the market's anxiety, which had previously intensified, is gradually settling down. In the meantime, market interest rates on instruments maturing after the fiscal year-end (March 1999) are on an upward trend, suggesting continued concern of market participants over liquidity risk.

Yields on long-term government bonds have rebounded since late November. Although stock prices considerably recovered after hitting the recent bottom in October, they have recently softened again. The yield spread (the government bond yield minus the expected earnings on stocks) remains extremely small or negative, reflecting market participants' continued cautious outlook on the future of the economy.

With regard to corporate finance, firms are further seeking to secure ample on-hand liquidity in fear of more difficulties in raising funds, especially toward the end of this fiscal year when the large-scale redemption of corporate bonds is scheduled. Meanwhile, private banks are continuing their cautious lending stance.

In these circumstances, various policy measures seem to have prevented serious credit shrinkage: the enhancement of [the ?]credit guarantee system[s ?] contributed to a recent increase in loans to small and medium-sized firms; and the Bank announced the introduction of new measures, in addition to the continued ample supply of funds, to facilitate firms' financing activities. Fundamentally, however, firms are still under severe fund-raising conditions. How corporate financing conditions towards the year-end and the fiscal year-end develop, and how such developments influence business activities and the whole economy, continues to warrant careful monitoring.