

The Bank of Japan's June report on recent economic and financial developments¹

Bank of Japan, Communication, 16 June 1999.

The Bank's View²

Japan's economy, at present, has stopped deteriorating, but clear signs of recovery have not been observed yet.

With regard to final demand, business fixed investment has basically been on a downward trend, although there was a slight improvement in early 1999. Recovery in private consumption continues to be weak on the whole. Net exports (exports minus imports) are decreasing slightly at present, due mainly to an increase in imports. Meanwhile, housing investment has been recovering. Public works seem to be increasing rapidly against the background of the surge in orders in early spring.

Reflecting such developments in final demand and continued progress in inventory adjustment, industrial production has stopped decreasing. The deterioration in corporate and consumer sentiment seems to have ceased due to this economic situation and the effects of measures taken to restore the stability of Japan's financial system. However, corporate profits remain weak, and employment and household income conditions are deteriorating as the unemployment rate remains historically high and wages continue to be below the previous year's level. In corporate finance, firms' concern about the availability of funds in the future has subsided, but has not completely disappeared yet.

As for the outlook, with the progress in inventory adjustment gradually paving the way for a recovery in production, the government's economic measures and the monetary easing by the Bank will continue to underpin the economy. Improvements in the financial environment, such as alleviation of concern about Japan's financial system, are also expected to exert positive effects on the economy gradually. Moreover, the recovery of overseas economies, especially of Asian economies, is likely to have a positive effect on domestic production. With respect to corporate activities, however, firms have started taking steps toward full-scale restructuring, facing the continued decline in profits. Although such corporate restructuring is expected to improve productivity, it may, in the short run, reduce fixed investment and

¹This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on June 14, 1999.

² The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on June 14 as the basis of monetary policy decisions.

discourage household expenditure through the resulting deterioration in employment and income conditions. Under such circumstances, it is still difficult to expect an immediate self-sustained recovery in private demand. Overall economic developments require careful monitoring in consideration of the above points. It is also important to promote structural reform in order to assure the economy's sustained growth in the medium term.

With regard to prices, import prices continue to rise due to the bottoming out of international commodity prices such as crude oil prices. The pace of decline in domestic wholesale prices is slowing due to a rise in prices of some products closely related to international commodities, such as those of petroleum products. On the other hand, corporate service prices continue to decline. Consumer prices remain weak. In relation to price developments in the future, there is a possibility that prices overall, which have been on a downtrend, will temporarily level off reflecting the rise in import prices. However, distinct narrowing in the output gap is unlikely for the time being even though the economy has stopped deteriorating, and wages continue to decline. Thus, downward pressure on prices is expected to remain.

In the financial market, the overnight call rate has stayed at nearly zero, and many financial institutions have become confident about the availability of liquidity. Interest rates on term instruments have declined further, reflecting the market's view that monetary easing will continue for some time. The Japan premium has almost disappeared. Furthermore, the yield spread between government bonds and private bonds—bank debentures and corporate bonds—has narrowed.

Yields on long-term government bonds have risen since late May to the current level of around 1.6-1.7 percent. Stock prices, which had generally been in the range of 16,000-17,000 yen, have recently risen and exceeded 17,000 yen.

The amount outstanding of funds in the call money market has continued to decrease. To date, this has not led to any difficulty in funds settlement, but close attention should be paid to future market developments.

With regard to corporate finance, private banks have basically retained their cautious lending attitude. However, constraint that had been caused by severe fund-raising conditions and insufficient capital base has eased considerably. Under these circumstances, major banks have gradually become more active than before in extending loans, especially for projects involving relatively small credit risks.

However, credit demand for economic activities such as business fixed investment remains weak. In addition, firms' moves to increase their on-hand liquidity are apparently settling down. As a result, credit demand in the private sector has weakened further.

Money stock (M_2 +CDs) has recently been showing a slightly higher year-to-year growth rate, mainly because firms' curtailment of on-hand liquidity has been less significant than that of the same period in the previous year.

In these financial environments, credit conditions, which had tightened previously, have eased somewhat.

The following continue to warrant careful monitoring: how actively investors will take risks; how far private banks will ease their lending stance; and how these changes will affect firms' propensity to invest.