

Bank of Japan's October report of recent economic and financial developments¹

Bank of Japan, Communication, 15 October 1999.

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The Bank's View²

Japan's economy has stopped deteriorating, and exports and production are improving at present. However, clear signs of a self-sustained recovery in private demand have not been observed yet.

With regard to final demand, business fixed investment has been on a downward trend. Recovery in private consumption continues to be weak on the whole, reflecting the persistent severity in employment and income conditions. Housing investment, which had been recovering, has recently peaked out. Meanwhile, public works have been rising, and net exports (exports minus imports) have continued to grow due to an increase in exports.

Reflecting such developments in final demand and continued progress in inventory adjustment, industrial production is increasing. Additionally, corporate profits have started picking up. In this situation, corporate sentiment has continued to improve. Such positive developments in corporate profits and sentiment, however, have not necessarily stimulated business activities, because firms strongly feel that they have excess capacity and employees and that they should reduce their debts to restore financial soundness.

As for the outlook, improvements in the overall financial environment partly due to the monetary easing by the Bank, along with a series of economic measures taken by the government, are expected to continue underpinning the economy. Moreover, the positive impact on domestic production of the recovery of overseas economies, especially of Asian economies, is likely to continue for some time. By contrast, leading indicators suggest a high probability of a moderate decrease in housing investment in the near future. The recent developments in public works orders indicate that public investment is likely to stop increasing. In addition, under cautious sales plans, firms are expected to continue corporate restructuring to improve their profitability. Although such restructuring is expected to improve productivity, in the short run, it reduces fixed investment and also discourages household expenditure through the resulting deterioration in employment and income conditions. Moreover, it seems that the recent appreciation of the yen will have an adverse effect on corporate profits in the near term. 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 have recently fallen slightly due to the appreciation of the yen, despite the rise in international commodity prices such as crude oil prices. Domestic wholesale prices are levelling off due to the progress in inventory adjustment as well as an increase in prices of some products closely related to international commodities, such as those of petroleum products. Consumer prices continue to be unchanged. Corporate service prices are still falling, although the pace of the decline is slowing. As regards the movements of overall prices in the future, they are likely to be flat,

¹ This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on 13 October 1999.

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

as the rise in crude oil prices to date will continue to be passed on to prices of other products for a while. However, substantial narrowing in the output gap led by a recovery in private demand is unlikely for the time being, 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 financial institutions have been confident about the availability of overnight funds. As for interest rates on term instruments, short-term rates maturing before the year-end have been moving at a historically low level. Meanwhile, rates maturing beyond the year-end are relatively high due to market participants' concern over the Year 2000 problem.

The Japan premium has continued to be nearly zero for short-term transactions, but a small premium has been observed for transactions maturing beyond the year-end.

Yields on long-term government bonds declined from late August to the level of around 1.6 percent. They rose somewhat thereafter and have recently been moving between 1.7 and 1.8 percent. The yield spread between government bonds and private bonds (bank debentures and corporate bonds) has been stable and noticeably smaller than before.

Stock prices fell below the 17,000 yen level in late September against the background of the weak tone in U.S. stock prices and the rapid appreciation of the yen, but subsequently rebounded reacting to the recovery in U.S. stock prices and the restoration of stability in the foreign exchange market. The prices are presently moving around 18,000 yen.

In the foreign exchange market, the yen surged against the U.S. dollar and reached the 103–104 yen level in the middle of and late September, but then declined to the current level of 106—108 yen to the dollar.

The amount outstanding of funds in the call money market has remained generally stable since the middle of June. 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, while carefully evaluating the credit risks involved.

However, credit demand for economic activities such as business fixed investment remains weak. In addition, some firms have been trying to reduce debts using their on hand liquidity. As a result, credit demand in the private sector has continued to be weak, and thus private banks' lending has remained sluggish. Meanwhile, issuance of corporate bonds and CP has recently been steady.

The year-to-year growth rate of money stock (M_2 +CDs) has declined to around 3.5 percent mainly due to the weakness in credit demand in the private sector.

In this financial environment, credit conditions 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 economic activities.