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

Bank of Japan, Communication 15 November 1999.

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The Bank's view[2]

Japan's economy, which had stopped deteriorating, is currently turning to improve, with exports and production increasing. However, clear signs of a self-sustained recovery in private demand have not yet been observed.

With regard to final demand, business fixed investment has been on a downward trend, although the pace of its decline is slowing. Recovery in private consumption continues to be weak through lack of notable improvements in employment and income conditions. Housing investment has recently peaked out, and public investment seems to have stopped rising. Meanwhile, net exports (real exports minus real imports) have increased further due to an upturn in overseas economies.

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 continues to improve. Regarding the employment condition, there are some indicators that suggest a slowdown of the decrease in the number of employees. The positive developments in corporate profits and sentiment, however, have not necessarily stimulated business activities, because firms still strongly feel that they have excess capacity and employees and that they should reduce their debts to restore financial soundness. In addition, efforts by firms to reduce personnel expenses have prolonged the severity of households' income conditions.

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 including those announced recently, 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, it is highly probable that housing investment will remain flat for the time being. In addition, under cautious sales outlook, firms are expected to continue corporate restructuring to improve their profitability. Such restructuring is unavoidable to enhance medium-term growth of the corporate sector and thereby that of the overall economy. In the short run, however, it reduces fixed investment, and also delays an improvement in employment and income conditions, thereby discouraging household expenditure. 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, even though an upturn in economic activities, such as production, is expected to give favorable effects to corporate and household income gradually. Consequently, economic developments still require careful monitoring, although the economy is turning to improve. Further, it is important to promote structural reform in order to encourage a recovery in private demand.

With regard to prices, import prices are increasing somewhat due to the rise to date in international commodity prices, such as crude oil prices. Domestic wholesale prices, notwithstanding the fall in prices of electric machinery, are flat due to an increase in prices of some products closely related to

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[1] This report was written based on data and information available when the Bank of Japan Monetary Policy Meeting was held on 12 November 1999.

[2] The Bank's view on recent economic and financial developments, determined by the Policy Board at the Monetary Policy Meeting held on 12 November as the basis of monetary policy decisions.

international commodities, such as those of petroleum products. Consumer prices remain unchanged. Corporate service prices are still falling slowly. As regards the movements of overall prices in the future, they are likely to be flat despite the continued fall in prices of some goods and services, 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 follow a declining trend. 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. The amount outstanding of funds in the call money market has remained generally stable since the middle of June.

As for interest rates on term instruments, short-term rates maturing before the year-end have remained at a historically low level. Meanwhile, rates maturing beyond the year-end are rising due to market participants' concern over the Year 2000 problem.

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

Yields on long-term government bonds rose to around 1.9 per cent in late October. They declined somewhat thereafter and are presently moving between 1.7 and 1.8 per cent again. The yield spread between private bonds (bank debentures and corporate bonds) and government bonds once stopped contracting. However, there has recently been a conspicuous narrowing in the spread, primarily between private bonds with relatively low credit ratings and government bonds.

Stock prices, after having declined in October against the background of the weak tone in U.S. stock prices, rebounded reacting to the recovery in U.S. stock prices, and are currently moving around 18,000-18,500 yen.

In the foreign exchange market, the yen has recently been traded at around 104-107 yen to the U.S. dollar.

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 are gradually becoming more active 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 basically stagnant, and thus private banks' lending has remained sluggish. Corporate bond issuance has been steady. Meanwhile, CP issuance has been increasing with the year-end approaching.

The year-to-year growth rate of money stock (M_2+CDs) has declined to 3.0-3.5 per cent 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.