Credit Creation Shows Signs of Recovery

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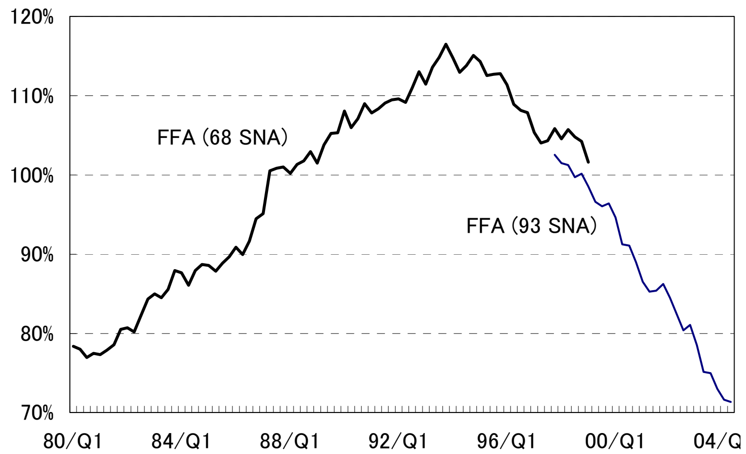
1. Corporate Sector Extends Financial Surplus

Since the collapse of the bubble economy, the so-called three excesses saddling the economy—debt, employment, and production capacity—have improved remarkably. Loans in the nonfinancial corporate sector, which exceeded 100% of nominal GDP right after the bubble burst, have decreased significantly in recent years (Figure 1). The unemployment rate has also fallen since fiscal 2003. And according to the Bank of Japan's *Tankan* survey, businesses report that excesses have eased in employment conditions and production capacity.

Figure 1 Excessive Debt Continues to Shrink (ratio to nominal GDP)



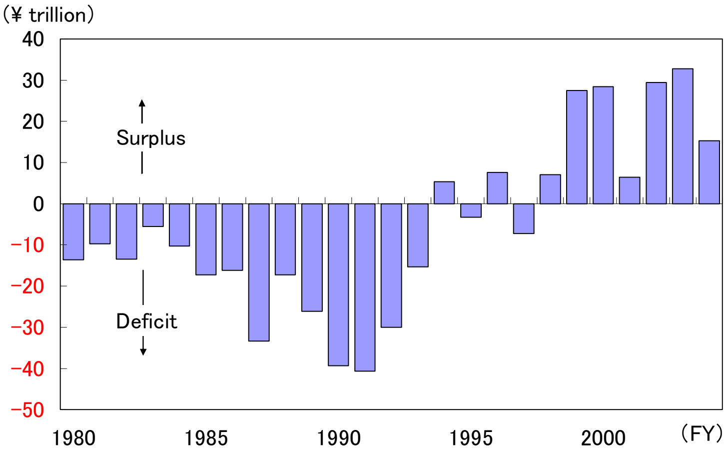
Notes: In *Flow of Funds Accounts* based on 93 SNA, loans of private nonfinancial corporations are divided by nominal GDP (seasonally adjusted). In *Flow of Funds Accounts* based on 68 SNA, loans of corporate business are divided by nominal GDP
Source: BOJ, *Flow of Funds Accounts Statistics*; Cabinet Office, *Annual Report on National Accounts*.

Moreover, companies continue to exhibit financial discipline. According to the most recent BOJ *Flow of Funds Accounts Statistics*, the corporate sector posted a financial surplus of 15 trillion yen in fiscal 2004. While this represents a decrease of 18 trillion yen from the previous year, it nonetheless marks the seventh straight surplus since fiscal 1998.

When the corporate sector first posted a financial surplus in fiscal 1998, companies were cleaning up balance sheets amid the worst possible situation. Demand for financing had chilled as the economy slowed and the financial system broke down, causing banks to clamp down on lending. Companies now enjoy a sound financial condition and record profits—particularly among exporters—which has allowed them to finance capital investment out of cash flows.

If these unique conditions persist, companies will continue not resorting to external financing. However, there are indications that financing patterns have started to change slowly but steadily.

Figure 2 Financial Balance of the Corporate Sector

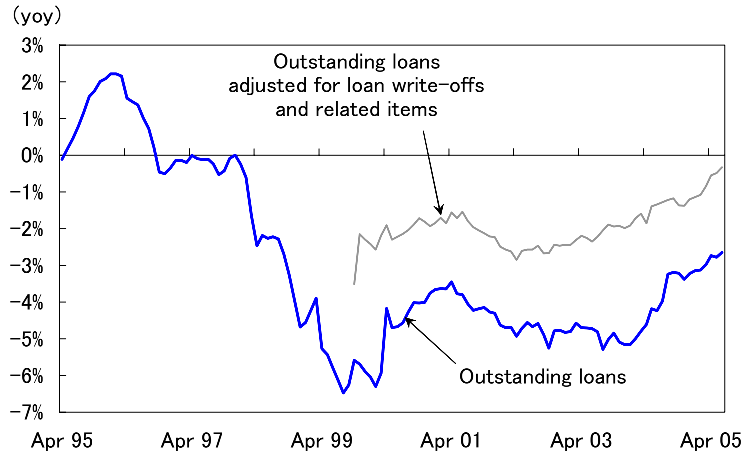


Source: BOJ

2. Recent Uptrend in Loans

According to data from *Principal Figures of Financial Institutions* (BOJ), while outstanding loans of banks have been declining since 1998, the rate of decline has steadily contracted since 2004 (Figure 3). In the most recent data, loans of city banks decreased by about 5% from the previous year, but loans of regional banks turned upward in October 2004.

Figure 3 Outstanding Loans of Banks



Source: BOJ

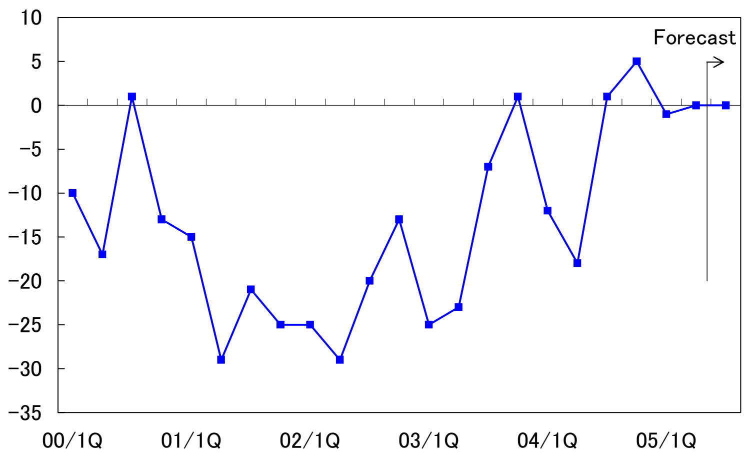
In other credit markets, outstanding CP and corporate bonds have either leveled off or edged up from the previous year. With IPOs and secondary offerings also increasing in stock markets, equity financing appear to be picking up.

Looking ahead, we predict that strong profits will continue to spur growth in capital investment in the near term, generating a growing demand for funds.

Another quarterly BOJ survey, the *Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks,* shows that corporate demand for loans dipped in early 2003 but has recovered nicely, and is predicted to continue increasing modestly (Figure 4).

Large banks turned the final corner in writing off nonperforming loans in March 2005, and have expressed a more accommodative lending stance for the future. As a result, loans are likely to grow alongside other forms of external financing.

Figure 4　DI for Demand for Loans (Firms)



Source:　BOJ

3.　Criterion to End Quantitative Easing

The accommodative lending stance of banks and renewed financing activity of companies could be interpreted as the portfolio rebalance effect long sought by quantitative easing (by supplying a large monetary base, the BOJ has tried to induce banks to change their asset structure, thereby stimulating lending and investment activity, and causing the money supply to grow).

Recently, markets have been speculating about a forthcoming shift in monetary policy. In predicting a policy shift, CPI trends remain the foremost indicator because of the BOJ's public commitment in its quantitative easing framework. Nonetheless, we believe that credit creation also warrants attention because as the economy improves, the recovery of credit creation to normalcy will influence their decision.