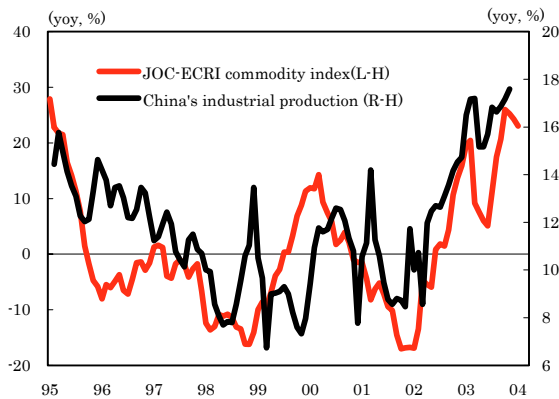


# Chinese Factors Squeeze Japan's Corporate Profits<sup>1</sup>

By Shun Maruyama, Economist ([shun.maruyama@ufji.co.jp](mailto:shun.maruyama@ufji.co.jp))

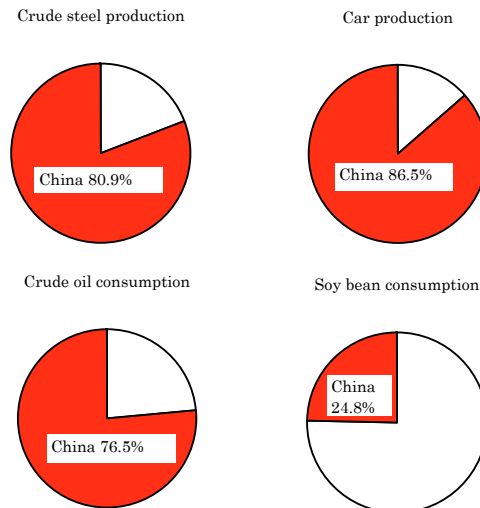
Since the end of 2001, commodity markets have continued to surge with the recovery in the global economy, returning to the high level reached before the Asian currency crisis. This price surge also reflects structural changes occurring in both the supply and demand sides: China's demand for raw materials has grown quickly in line with its rapid economic development. As a result of the long, sluggish market, commodity producers have made production adjustments and reorganized at an international scale.

China's economic developments and commodity markets



Note: Figures of JOC-ECRI index are those at the end of month. The latest date as of Jan. 16, 2004. Figures of China's industrial production are the yoy growth rate of 3-month moving average. The latest data as of Nov. 2003.  
Source: US Economic Cycle Research Institute (ECRI), China's State Statistics Office

China's share in the increase in world demand



Source: Japan Iron and Steel Federation, BP Amoco, US Dept. of Agriculture, Japan Automobile Manufacturers Association

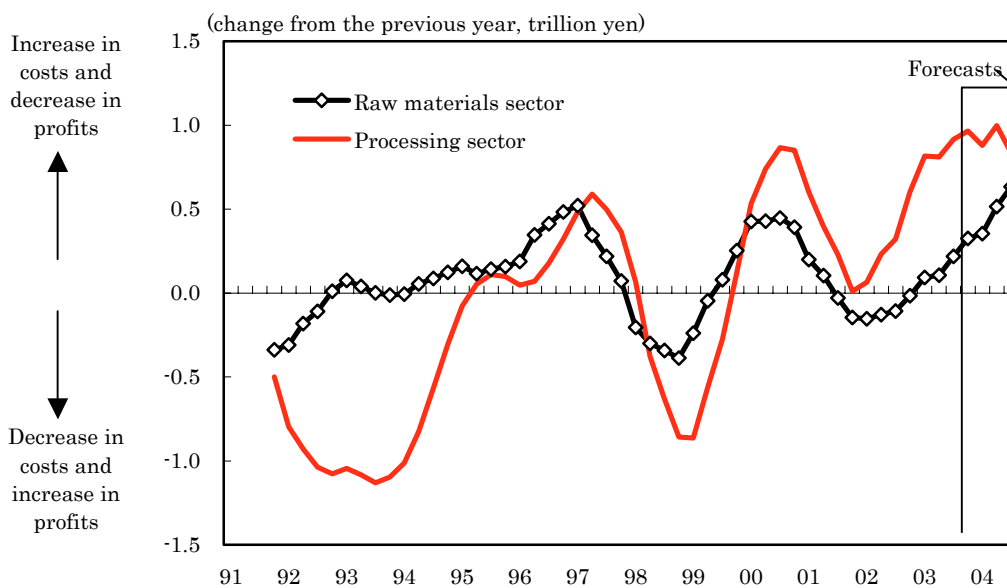
As imports satisfy about 60% of the demand for raw materials in Japan, a price surge in commodity markets causes an outflow of income overseas. The issue of who carries the costs depends on the economic environment in each case. The upstream raw material sector has mainly suffered from an increase in costs due to the surge in commodity markets; as demand at home decreased and excess capacity developed, the raw material sector could not charge higher prices despite an increase in costs. Instead, raw material producers tried to cut costs by slashing fixed costs and profits. But this is not the case today. Since restructuring and a concentration of capacity has been achieved, raw material producers can afford to charge higher

<sup>1</sup> This is an English summary of a report originally published on January 21, 2004. The full report is available only in Japanese, but the author will answer questions regarding the topic by e-mail.

prices now. Meanwhile, the downstream processing sector, with its excess capacity, is facing both a surcharge from raw material producers and price competition owing to cheap imports from China and other Asian countries, and its profits have been squeezed.

According to our estimates, the total costs of raw materials for the Japanese economy as a whole increased by 4.64 trillion yen during the last 4 quarters (2002/4Q to 2003/3Q), of which 0.46 trillion yen was accounted for by the raw materials sector and the remaining 4.18 trillion yen in costs was carried by the processing sector. If commodity prices continue to rise by 10% in one year, the total costs of raw materials will increase by 5.70 trillion yen. In assuming that the rate of cost transfer from raw material producers to the processing industry will remain unchanged, costs will increase by 2 trillion yen in the raw material sector and by 3.70 trillion yen in the processing sector. As a result, it is likely that the gap in profitability between these two sectors will widen further.

Price surge in commodity markets and an increase in costs by sector



Note 1: Figures are based on 4 quarters moving average.

Note 2: Raw materials sector comprises steel, petroleum and coal products, pulp, paper, and wood products, chemicals, and non-ferrous metals industries.

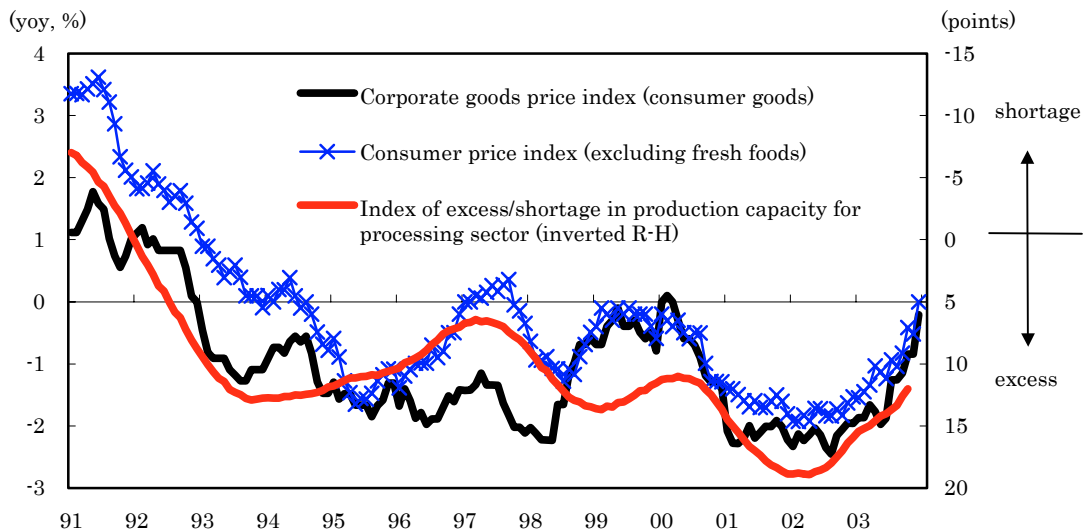
Processing sector comprises electrical machinery, general machinery, precision instruments, and transport equipment industries.

Note 3: Forecasts are based on the assumption mentioned in the report.

Source: MOF, BOJ

Meanwhile, if the processing sector transfers the increased costs to the consumer in the form of selling prices, consumers will suffer from an increase. Nevertheless, the strong growth in China's production, causing a rise in commodity markets, has increased inflationary pressures in the upstream sector, while simultaneously strengthening deflationary pressures in the downstream sector. Given these conditions, even if commodity prices continue to rise, an increase in consumer prices will be limited. It is unlikely that the price surge in commodity markets will help Japan escape deflation; instead, profits are likely to be squeezed primarily in the downstream processing industry. In order to resolve deflation, not only a rise in cost-up pressures from the upstream sector, but also an additional cut in the demand and supply gap through an expansion in demand or a slash in production capacity in the downstream sector, is required.

**Demand and supply gap in the processing sector and prices in consumer goods**



Note 1: Processing sector comprises machinery, fabricated metals, and other manufacturing.

Note 2: Index of excess/shortage in production capacity is calculated as follows:

a: Production index based on production capacity = utilization rate \* index of production capacity /100

b: Index of excess/shortage in production capacity = index of production capacity - Production index based on production capacity

c: Pick up 4 quarters when BOJ Tankan's DIs for Production Capacity shift from excess to shortage during the 2 middle quarters, and adjust the 4-quarters' average of the index (b) for the same 4 quarters to equal to zero.

Note 3: Consumption tax is excluded in the corporate goods' price index, and effects of consumption tax are excluded from consumer price index.

Source: BOJ, Ministry of Public Management, Home Affairs, Posts and Telecommunications, METI

\*The information and the views contained herein are subject to change without notice.

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