October 23, 2012

Global Watch

October 2012

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§ Japanese Economy

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§Japanese Economy

1. Overview of the Japanese Economy

A Pause in Movement toward Improvement and Concerns Regarding Further Deterioration

By Shinichiro Kobayashi, Senior Economist

Movement toward improvement in economic conditions has paused. If declines in exports and production continue, there is a risk that the economy will enter a recessionary scenario.

Trends in exports are continuing to be weak. Exports in real terms in August edged down 0.6% below the level of the previous month—which is a small margin of decrease, but is also the fourth consecutive month of decline. The value of exports was also weak, reaching the lowest level seen since May 2011, when exports were impacted by supply restrictions associated with the recovery from the Great East Japan Earthquake disaster. Looking at export destination regions, the fundamental strength of exports to the United States has been maintained. However, exports to Europe are slack, and exports to Asia are continuing to decrease.

This weakness in exports has become a factor contributing to the weakness of production. The index of industrial production in August declined 1.3% from the previous month, and—paralleling the situation with respect to real exports—the level of the index was the lowest since May 2011. The forecast index for production in September—indicating a month-on-month decrease of 2.9%—reflects the fact that manufacturers are continuing to scale down their production plans (followed by a leveling out in October), and if actual performance is in line with the forecasts, production in the July-September quarter will be down 3.6% from the previous quarter, the second consecutive quarter of decrease.

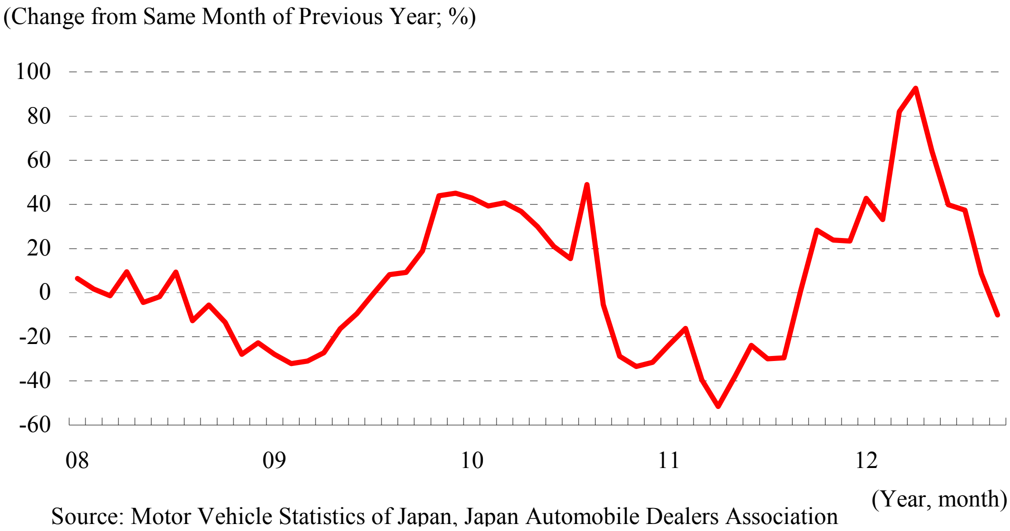
Accumulating inventories are another factor restraining production. Strengthened production reduction measures caused a 1.6% month-on-month downturn in the inventory index in August, but inventory levels remain close to their December 2008 levels, which are the highest levels recorded since the Lehman shock. Although a portion of the basic materials industry is continuing to make progress with inventory adjustments, many companies—including such electronic component and device industry members as semiconductor and LCD makers as well as such information-communications equipment industry members as flat-screen TV and personal computer makers—are continuing to carry high levels of inventory, and this situation is likely to exert a restraining influence on production for the time being.

However, the September version of the Bank of Japan (BOJ)'s quarterly *Tankan* short-term economic survey of enterprises found that the business condition diffusion index ("favorable" minus "unfavorable" responses) for large manufacturers was –3, a deterioration of two points since the previous survey. The diffusion index for large nonmanufacturing companies remained roughly unchanged at +8. In view of recent trends in production and exports, it would not be surprising to see a rapidly progressing deterioration of business condition diffusion indexes, but the actual pace of deterioration in companies' perceived business conditions has been unexpectedly slow. There is a possibility that this may reflect the fact that, although demand is weakening, the impact of that weakening on corporate performances has remained minor so far. Regarding the diffusion index for prospective business conditions through December, large nonmanufacturing companies have recorded a three-point deterioration, to +5, while large manufacturers have maintained a –3 index, indicating that they anticipate a halt in the deterioration of their business conditions. It appears that companies have not become extremely pessimistic about their outlooks.

There has been a pause in the trend of recovery in personal consumption. The household budget survey for August found that real expenditures (for households with two or more members) were up 2.2% from July, a robust increase that also represents a reaction to the trend of month-on-month declines recorded through July. However, the acceptance of applications for subsidies for eco-car purchases ended on September 21, and a drop in automobile sales is expected going forward. Automobile sales in September were down 10.1% from the same month of the previous year, the first decline in year-on-year sales seen for 13 months, and it is likely that the margin of decrease will expand in October and subsequently. As increases in personal income appear unlikely, the fading away of the positive impact of strong automobile sales will inevitably lead to a weakening of personal consumption.

Going forward, the increase in public investment associated with the implementation of Japan's supplementary budget is designed to support economic conditions, but the persistent slackness of exports and projections of a drop in personal consumption indicate a high level of likelihood that the momentum of economic recovery will further weaken. In the cases of further deterioration in the export environment—owing to such situations as further deceleration of recovery in overseas economies and further appreciation of the yen—and an increase in the size of production drops—owing to inventory adjustments—it is likely that the economy may face a steep uphill climb.　(2012.10.3)

Chart 1: Number of Newly Registered Motor Vehicles
(Passenger Cars/Excluding Mini-Vehicles)



Source: Motor Vehicle Statistics of Japan, Japan Automobile Dealers Association

2. *Topic of the Month*

Increasing Market Penetration of Imported Capital Goods in Japan

By Miki Ohata, Economist

Traditionally, Japan has had a relatively high level of export competitiveness with respect to capital goods associated with investments. Excluding transport equipment, however, the presence of imported products within domestic shipments of capital goods has been increasing in recent years. According to the Ministry of Finance's *Trade Statistics of Japan,* the value of capital goods imports excluding transport equipment has almost relentlessly risen since the 1990s, reaching the record level of ¥16.4 trillion in fiscal 2007. Although capital goods imports have slackened owing to the impact of the collapse of Lehman Brothers, as of fiscal 2011, the share of Japan's total import value accounted for by capital goods imports was approximately 20%.

Looking at the import penetration index of capital goods[1] (excl. transport equipment), or the share of imports among domestic shipments of capital goods, one finds that the import penetration index rose greatly during the period from the mid-1990s through the first half of the 2000s. Subsequently, a rise in shipments of domestic products during the economic expansion period in the mid-2000s caused a temporary drop in the import penetration index. During the latter half of the 2000s, however, the index renewed its uptrend, reaching a record high level of 25.6% in the 3rd quarter of 2011 and is remaining at high levels in the vicinity of 25% since that time. In recent years, attention has tended to be focused on the diffusion in Japan of such imported consumer goods as apparel and consumer electronic products, but an examination of the import penetration index shows that the index for capital goods (excl. transport equipment) has been above the level for consumer products since 1997.

When the rising import penetration index causes a portion of the expansion of domestic demand to be cancelled out by import increases, GDP will not rise as much as domestic demand. Accordingly, it can also be said that, in the case of growth in domestic capital investments, the GDP boost from such growth is weaker than previously. However, the rising import penetration index does not necessarily indicate that Japan's international competitiveness with respect to capital goods excluding transport equipment is declining. There is also the possibility that capital goods manufacturers are allowing for the import of low-value-added capital goods in line with their strategies for focusing on increasing their exports of high-value-added capital goods and thereby elevating their productivity. In fact, Japan's exports of capital goods excluding transport equipment are robust, and this clearly indicates that the country's domestic production of capital goods is not being severely impacted by imports. (2012.10.3)

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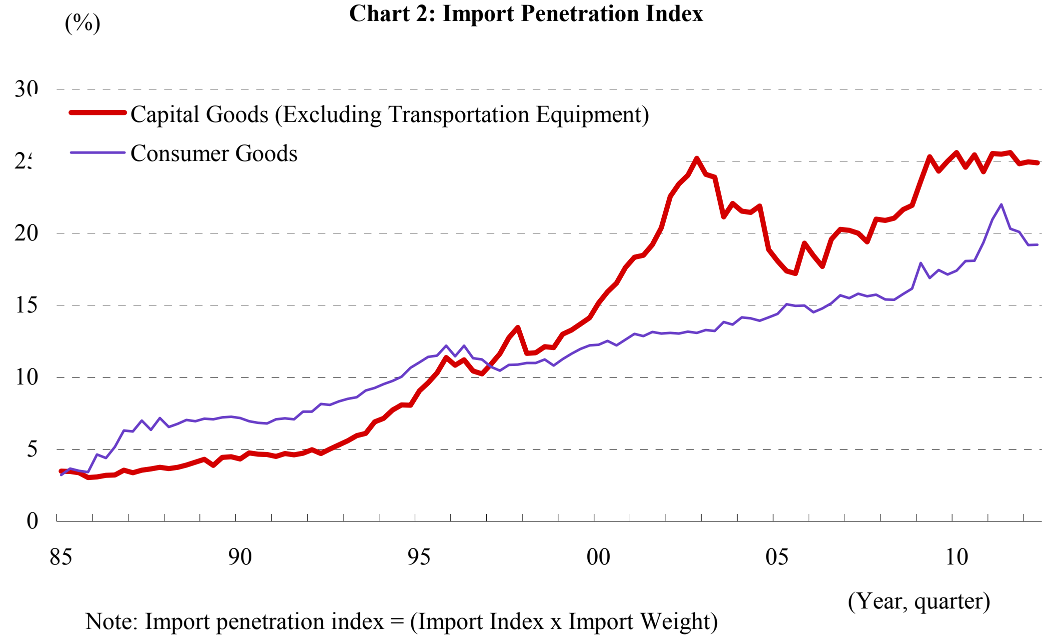
[1] The definition of capital goods may sometimes include such items as raw materials, work-in-process, and finished goods inventories, but Japan's Ministry of Economy, Trade and Industry, for its *Indices of Industrial Domestic Shipments and Imports*, has defined capital goods as goods oriented toward capital investments.

Chart 2: Import Penetration Index



Note: Import penetration index = (Import Index x Import Weight) ÷ (Total Supply Index x Total Supply Weight)

Source: Indices of Industrial Domestic Shipments and Imports, Ministry of Economy, Trade and Industry