3 June 2016

Economic Report

Global Watch May 2016

1. Overview of the Japanese Economy: Remains Roughly Flat with Weak Trends in Some Areas

By Shinichiro Kobayashi, Senior Economist

The economy continues to be basically flat, and weakness has emerged in some sectors.

The area where the risk of a downtrend is rising the most is in the manufacturing sector. The index of industrial production in March (preliminary figure) rose a firm 3.6% over the previous month, because of the impact of a rebound in automobile production and other factors. However, during the January-March quarter, production in manufacturing decreased 1.1% from the previous quarter, reflecting a weaker trend. The survey of production forecasts calls for a rise of 2.6% in April over the previous month, centering around the transportation machinery industry, followed by a decline of 2.3% in May, but these forecasts do not take account of the impact of the earthquake in Kumamoto, Japan, which occurred on April 14. After the earthquake, if we take account of the stoppage of production of automobiles and other products, there is a strong possibility that actual production may be substantially below the planned levels. Moreover, if we also take account of the slump in overseas demand for smartphones and general machinery and the rise in inventories, there is a possibility that there may be a further decline in the April-June period compared with the previous quarter.

Exports also lack strength. Real exports in March rose 1.1% over the previous month, the second consecutive month-to-month rise, but, on average, appear to be approximately flat. Exports, mainly of automobiles and other products, to the United States are remaining firm, but, reflecting the trend toward deceleration in the economy and the slump in demand for smartphones, exports to the rest of Asia continue to be weak.

On the other hand, orders for machinery and equipment (private sector, excluding shipping and electric power) in February dropped a sharp 9.2% from the previous month, but this was a reactionary decline due to a steep rise in large orders in the previous month. The basic firmness of private capital investment in the GDP statistics has been confirmed, and, against a background of an uptrend in corporate performance, the improving trend is likely to continue.

In the household sector, the tightness in the supply and demand balance for labor remains unchanged, and the unemployment rate in March was at a low level of 3.2%, while the ratio of job openings to job seekers rose to 1.30

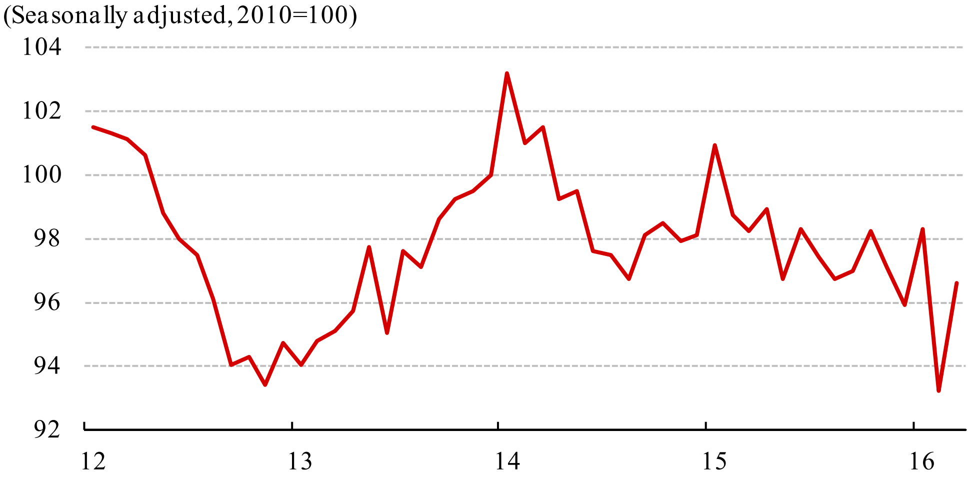
times, as high as during Japan's bubble economy. Amid this economic environment, wages also are showing improvement, and total per capita cash compensation of workers (preliminary figure) in March rose 1.4% over the same month of the previous year. The major factor boosting overall compensation is non-scheduled compensation payments, while regularly scheduled compensation showed a more moderate increase of 0.4% year on year for the month.

Personal consumption, however, on average remains weak. According to the March Family Income and Expenditure Survey (covering households of two or more persons, seasonally adjusted), consumer spending rose 0.5% over the previous month. Although this was the second consecutive month-to-month rise in this figure, the level of consumer spending was 5.3% below the same month of the previous year. The moderate improvement in wages and the continuation of price stability are expected to provide support for personal consumption, but the delay in recovery of consumer confidence and the trend toward greater frugality among consumers are likely to prolong the emergence of any trend toward improvement for some time.

Note that the consumer price index (comprehensive index, excluding fresh food) in March was 0.3% below the same month of the previous year, thus turning negative again. It is believed likely that the decline in energy prices and lower import prices in general because of the appreciation of the yen will continue going forward, and the margin of decline is forecast to widen.

Although the early formulation of a supplementary budget may eventually result in demand for reconstruction and recovery, in the short term, there is a possibility that the negative impact of the Kumamoto earthquake may spread. Specifically, (1) the stoppage and delay in the recovery of production activities in Kyushu may spread through the supply chain to the rest of the country and (2) the trend toward restraining spending may be aggravated by the deterioration in consumer confidence mainly in the Kyushu region. The temporarily pessimistic mood regarding future economic conditions in overseas economies may recede as the commodity markets bottom out and the appreciation in the value of the dollar is corrected. On the other hand, however, there are also concerns that the recovery trend in the U.S. economy will weaken. Thus, although there are hopes that improvements will be seen in Japan's employment and income conditions, capital investment will rise, and exports will improve along with recovery in overseas economies; in the short term, the risks of a downturn in Japan's economy are increasing. (2016.5.10)

Chart 1: Trends in Industrial Production Indexes



Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*

2. Topic of the Month: The Meaning of the Rise in the Number of Months Backlog of Machinery Orders

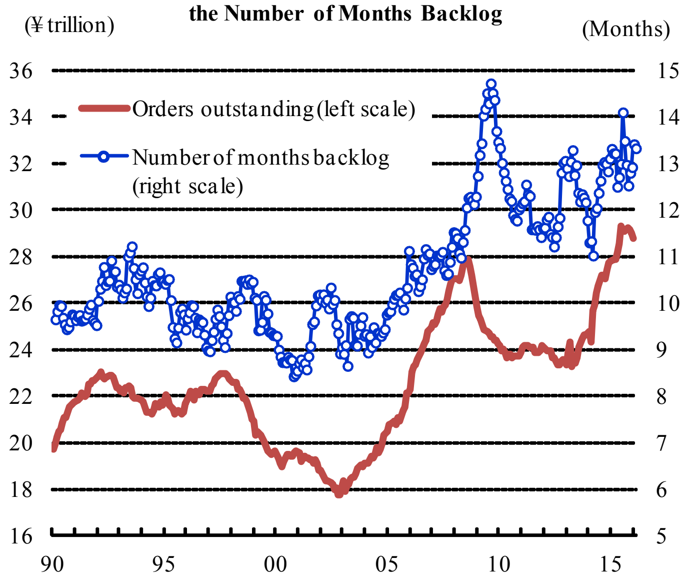
By Ruriko Toshida, Economist

The backlog of machinery orders, which had been rising after the collapse of Lehman Brothers, has recently peaked out, since the margin of the amount of new orders and sales has narrowed. Nevertheless, the amount of machinery orders is still at a historic high, and the order backlog measured in months, which is calculated by dividing the backlog of orders by the sales, also remains high, at over 12 months (Chart 2). From a computational perspective, this means that companies have sufficient orders, as much as 12 months of sales, even if they receive no additional orders for a year. However, does it mean that the performance of machinery manufacturing companies is stable?

In the past, for example in 2009 and 2012, the order backlog in months also rose substantially. For those cases, examining the changes in the amount of orders and sales, it can be said that the cause was the sudden decline in the amount of sales, which is the denominator of the fraction. In these cases, the increase in the number of months of backlog does not indicate that the performance of machinery manufacturers is stable.

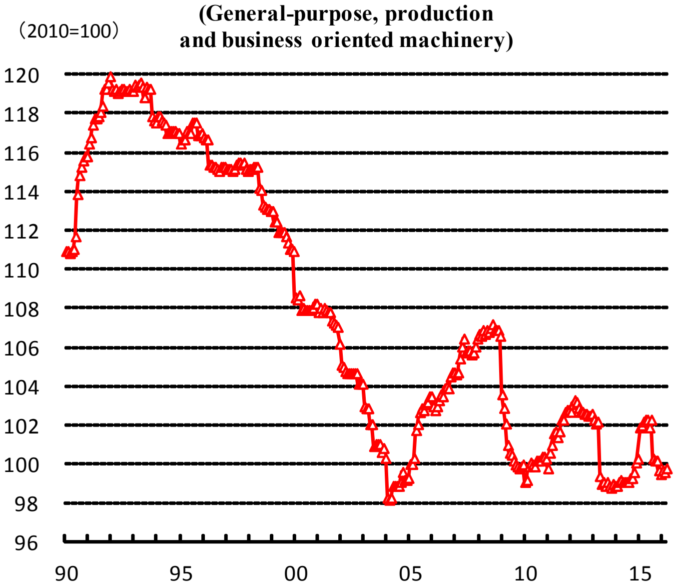
On the other hand, the recent rise of the order backlog in months has not been caused by the major fluctuations in the amount of sales, but the main reason is the increase in the amount of backlog of orders. In other words, unlike the examples of the past, the rise in the order backlog in months has been expanding, due to the increase in the numerator of the fraction. If the amount of orders continues to rise in this way, it can be concluded that the performance of these companies is favorable. Nonetheless, even though the amount of orders has increased, as the change in production capacity of the general-purpose, production and business oriented machinery manufacturers shows, companies' capacity has remained almost unchanged (Chart 3). This means that these manufacturers are not increasing their production capacity in line with the increase in the amount of orders. This implies that restraining the increase of sales makes the number of order backlog in months rise. In this case, even if the backlog of orders increases, it will be difficult for machinery manufacturers to raise their performance level. Moreover, even if the demand for private capital investment increases, they might not be able to respond to it. (2016.5.10)

Chart 2: Orders Outstanding and the Number of Months Backlog



Source: Cabinet Office, *Survey of Machinery Orders*

Chart 3: Production Capacity (General-purpose, production and business oriented machinery)



Note: Data before 2008 are those of General Machinery.
Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*