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Japan Economic Perspectives

Japan's Broadening Downturn: Is Capital Spending Next?

Drivers of Japan's economic growth appear to be disappearing, one after another. Slowing exports and private consumption have already occurred, as well as a deterioration in industrial production and GDP growth. Now data on machinery orders and results of the December Tankan Survey indicate private capital spending may be in line for a drastic slowdown.

Machinery orders, a leading indicator of capital spending, were shockingly weak again in October. Core orders declined 3.1% month-over-month, down for the second consecutive month and significantly below the market expectation of a 2.4% gain. The downtrend is more clearly observed on a year-over-year basis, which shows orders dropping a huge 9.9% in October, down for the first time in nine months and the largest fall in two years and two months **(Display 1)**.

The slowdown in machinery orders was much faster than we expected. If the trend continues, we may significantly downgrade our capital spending forecast for 2005.

December Tankan Survey Results Confirm Economy's Slide

The business conditions diffusion index for large manufacturers in the Bank of Japan quarterly Tankan survey was down for the first time in seven quarters in December, deteriorating to 22 from 26 in September **(Display 2)**. Pretty much in line with market expectations, this result is consistent with weakness in other economic indicators such as industrial production and GDP. To be sure, industrial production showed a quarter-over-quarter decline in the third quarter for the first time in five quarters **(Display 3)**, and nominal GDP continued to see negative quarter-over-quarter growth in the second and third quarters. The three-month outlook for the index showed a further worsening to 15, which is consistent with the industrial production forecast of the Ministry of Economy, Trade and Industry of a second consecutive quarter-over-quarter decline in the fourth quarter.

Marked deterioration was seen in the electrical machinery component of the index, which fell from 28 to 11, due to a sharp deceleration in demand and huge unintentional inventory accumulation **(Display 3)**. Given overall industrial production growth, this trend is likely to spread to other industries, although some continued to see a marginal improvement in December—such as iron and steel which rose from 58 to 60, general machinery which rose from 38 to 43, and precision machinery which rose from 38 to 41.

Meanwhile, the large non-manufacturers' diffusion index remained unchanged at 11 in December. The diffusion index for small manufacturers also remained unchanged at 5 and for small non-manufacturers improved from September's –17 to –14. Yet these indexes are lagging indicators. The three-month outlook for small manufacturers shows a significant worsening to –1, and for small non-manufacturers to –18. Large non-manufacturers expect their business conditions diffusion index to fall to 10 in March.

Attracting particular attention in the December survey was the fiscal 2004 capital spending plan for large firms, which was revised up from 6.1% in the September survey to 7.7%—against a market expectation of 5.9%. Although superficially this appears to be good news for the economy, we think it could be a warning about the pace and direction of future capital spending. Indeed, despite upward revisions to the capital spending forecast throughout the year, final capital spending growth for the first half of the fiscal year (April to September) was unexpectedly revised down significantly, from 13.0% year-over-year in the September survey to a mere 4.6% in December. This represents a postponement of capital spending plans for the first time in the current recovery phase, and may be a signal that firms have become hesitant. Thus, the upward revision to the forecast for capital spending in the second half could eventually be revised down as well, as firms become more cautious.

In a deteriorating economic environment, we don't think caution is such a bad thing.

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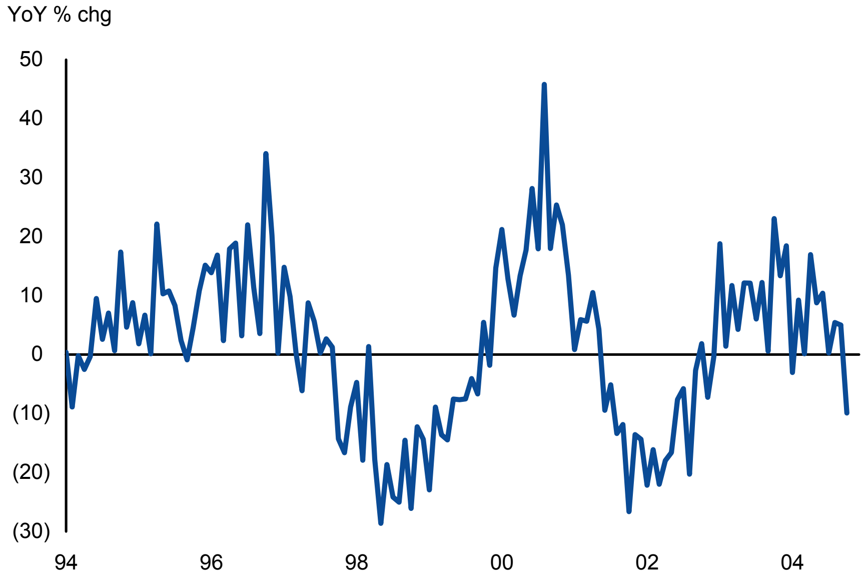
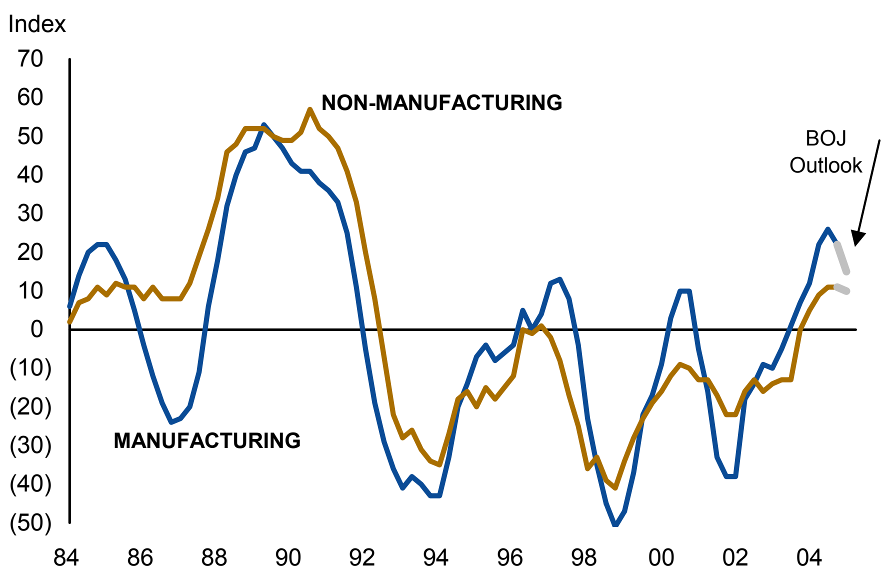
Display 1: October Machinery Orders Suggest Fall in Capital Spending Could Be Ahead
Core Machinery Orders



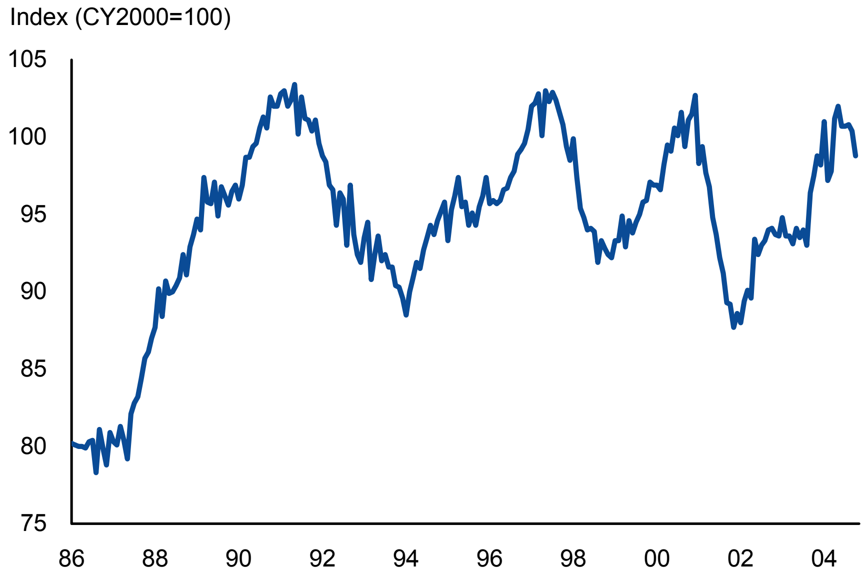
Source: Cabinet Office, December 17, 2004

Display 2: Large Manufacturers Business Conditions Worsened for the First Time in Seven Quarters
Business Conditions Diffusion Index for Large Firms



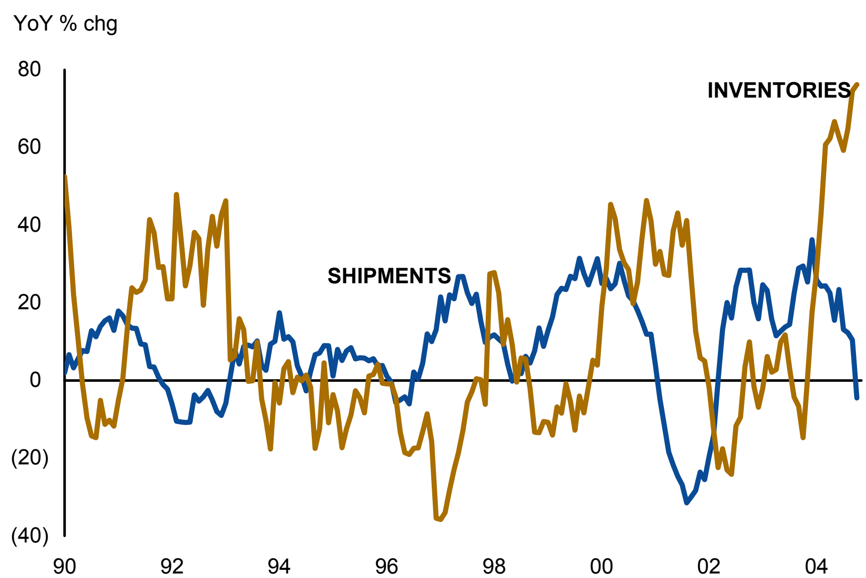
Source: Bank of Japan, December 17, 2004

Display 3: Industrial Production is Headed Downwards
Industrial Production Index



Source: Ministry of Economy, Trade and Industry, December 17, 2004

Display 4: Electronic Parts Inventories Skyrocketing
Shipments and Inventories in Electronic Parts



Source: Ministry of Economy, Trade and Industry, December 17, 2004