

# JAPAN ECONOMIC WEEKLY



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# Japan Economic Perspectives

## Despite Second Quarter Decline, Industrial Production Should Turn Positive Again

At first glance the deterioration in industrial production growth in the second quarter looks worrisome. Indeed, production declined 0.4% following a 1.7% advance in the first quarter. Yet export volumes, retail sales and shipments all show signs that production could return to positive growth during the second half of the year.

In June, industrial production grew for the first time in two months, rising 1.5% after declining 2.8% in May. This was very close to the Ministry of Economy, Trade and Industry (METI) outlook of 1.7%, and pretty much in line with market expectations. But it wasn't enough to make up for a lackluster quarter. On a year-over-year basis, production grew only 0.2% in the quarter, a further slowdown from 1.4% in the first three months of the year and the lowest rise in three years (**Display 1**).

As a result, GDP growth is likely to be near zero for the quarter, with real GDP growing at a rate of 0.2% (0.7% annualized), in our estimation.

But the outlook for the third quarter is somewhat brighter, given that export volume growth appears to be bottoming and domestic retail sales appear to be rising. Export volumes rose 0.4% year-over-year in June, a marked improvement from respective growth of 1.4% and -2.5% in April and May. And, retail sales grew 3.2% year-over-year in the second quarter overall, its highest rise in more than eight years (**Display 2**).

The METI outlook for July production has been revised up accordingly, from -1.2% month-over-month to -0.2%. Moreover, the METI expects August production to rise a solid 1.9% (**Display 3**). If this occurs, the July-August average of production will be 0.7% higher than the April-June average, implying positive production growth in the

third quarter. In year-over-year terms, the METI projection for the month of July points to -1.4% growth (the largest drop since June 2002) which is expected to be followed by a sharp rebound of 3.2% in August.

## Mixed Story From Shipments Data

Signs of a production rebound in the second half are also seen in shipments and inventory data. Industrial shipments rose 2.0% month-over-month in June after falling 3.0% in May, and in year-over-year terms showed a modest rebound from May's -0.6% to 0.3%. Moreover, inventories were down for the first time in three months in June (-0.2%) and in year-over-year terms moderated from May's 2.8% to 2.4%.

But when broken down by product category, the data on shipments presents a mixed picture. Indeed, capital goods shipments saw a rise of only 0.3% year-over-year in June, resulting in second-quarter shipments being up just 2.4% year-over-year, a further deceleration from the first quarter's 5.5% and the lowest reading in more than two years—evidence that capital spending growth is still slowing (**Display 4**). In consumer goods shipments, however, although non-durable goods remained sluggish at -0.2% year-over-year in the second quarter, growth of durable goods shipments rebounded to 1.4% from 0.7% in the first quarter. Finally, shipments of intermediate producer goods declined 0.7% year-over-year in the second quarter, the largest fall since the first quarter of 2002. Nonetheless, on a monthly basis, June growth of 0.4% was a significant improvement after declines in both April and May, implying that the trend may be turning positive (**Display 5**).

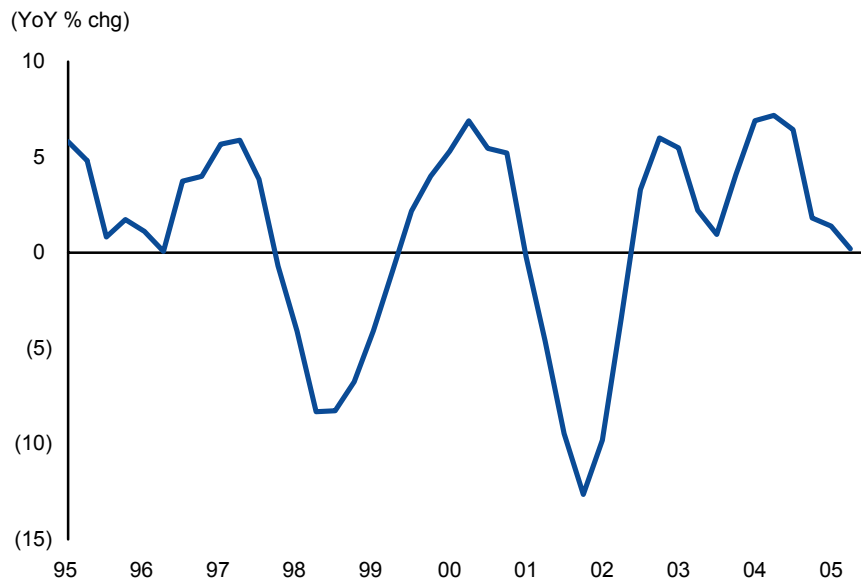
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## Display 1: Growth Momentum of Industrial Production Is Slowing

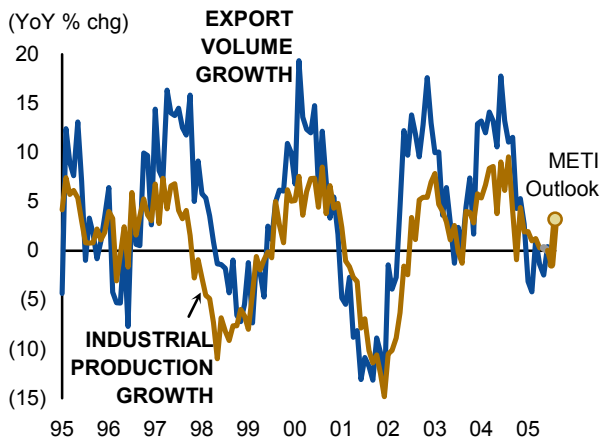
### Industrial Production Growth



Source: Ministry of Economy, Trade and Industry. August 5, 2005

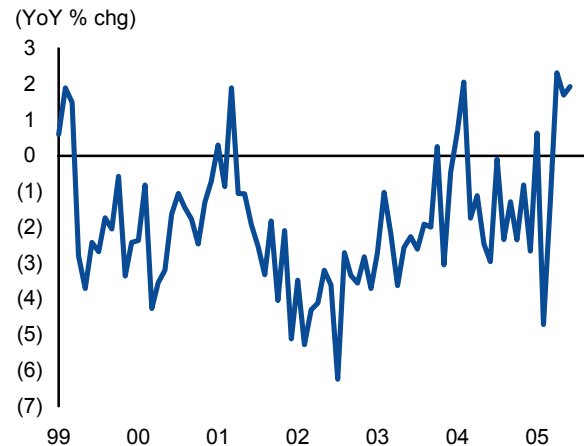
## Display 2: Outlook for Third Quarter Production Is Somewhat Brighter, Given Export Volume Growth May Be Bottoming and Retail Sales Have Shown Robust Growth in Recent Months

### Industrial Production and Export Volume Growth



Source: Ministry of Finance, Ministry of Economy, Trade and Industry. August 5, 2005

### Retail Sales Growth (Excluding Fuel Sales)



Source: Ministry of Economy, Trade and Industry. August 5, 2005

**Display 3: METI Outlook Paints a Somewhat Brighter Industrial Production Picture for the Third Quarter**

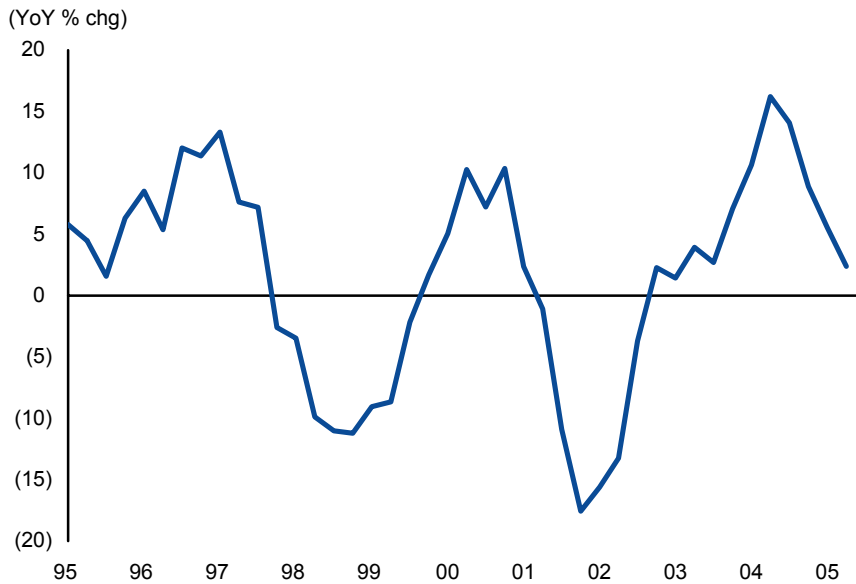
Industrial Production Level



Source: Ministry of Economy, Trade and Industry. August 5, 2005

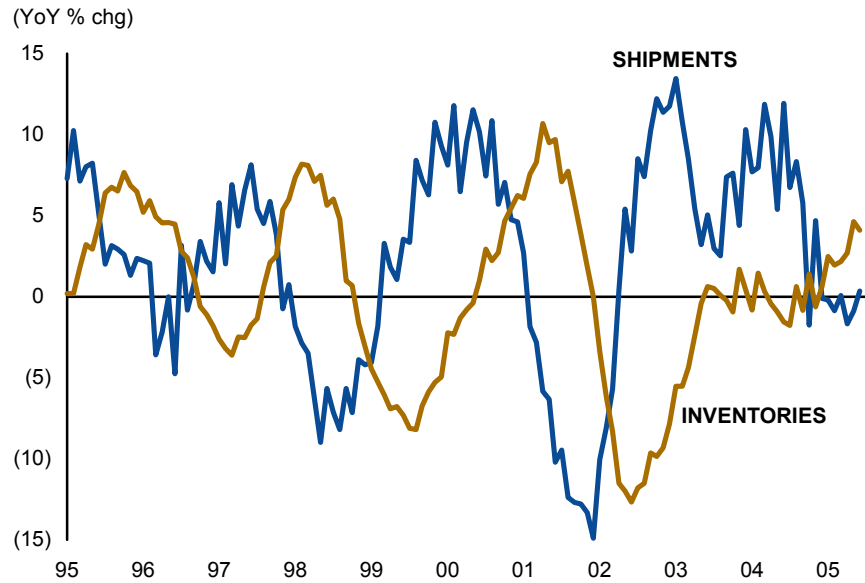
**Display 4: Capital Goods Shipments Are Still Slowing...**

Capital Goods Shipments Growth



Source: Ministry of Economy, Trade and Industry. August 5, 2005

## Display 5: ...But Producer Goods Shipments May Be Bottoming Producer Goods: Shipments and Inventory Growth



Source: Ministry of Economy, Trade and Industry. August 5, 2005