

JAPAN ECONOMIC WEEKLY



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Japan Economic Perspectives

Spending at Small Firms May Hold Key to Japan's Economic Outlook

Year-over-year growth in capital spending showed a small rebound in the first quarter in Japan, registering growth of 7.4% after reaching a five-quarter low of 3.5% in the fourth quarter. We remain cautious about capital spending going forward, however, as this was still significantly below third quarter growth of 14.4% (**Display 1**). Moreover, the data show a large contrast between spending at large and small firms. In the first quarter, spending growth at large firms (capital of over 1 billion yen) rebounded sharply from 5.6% in the fourth quarter to 14.4% in the first—the highest year-over-year rise since 1991—but spending at small firms (capital of 10 million yen to 100 million yen) was slashed to the lowest growth of nearly three years, at -6.2%, following growth of -0.7% in the fourth quarter. This has important implications for Japan's capital spending outlook. Indeed, as small firms tend to react faster to business conditions than large firms, capital spending at small firms is usually an indicator of future spending of large firms (**Display 2**).

Slowing corporate profit growth supports our cautious capital spending outlook. According to the quarterly corporate survey conducted by the Ministry of Finance, recurring profit growth on a year-over-year basis for all industries slowed from 17.6% in the fourth quarter to 15.8% in the first, the lowest reading in six quarters (**Display 3**). And, despite the fact that first-quarter sales showed the highest year-over-year rise in nine years at 6.0%, operating profits rose only 10.7% year-over-year in

the quarter, just one-third of both second- and third-quarter growth of 33.4% and 29.4%, respectively.

Furthermore, the underlying trend in machinery orders, a leading indicator of capex, is weakening. In April, core private domestic machinery orders, excluding the volatile orders from shipbuilding and electric power, declined 1.0% month-over-month, down for the first time in three months. Year-over-year growth slowed drastically, from March's 13.2% to a mere 2.5% in April (**Display 4**). This downward shift is almost in line with the Cabinet Office outlook, which expects second-quarter orders to decline 2.8% year-over-year, down for the first time since the fourth quarter of 2002 (**Display 5**).

But just as capital spending at small firms makes us uneasy, machinery orders at small firms brings some hope to the outlook. To be sure, machinery orders from small and medium-sized firms (orders through agencies) surged 34.3% in April, the biggest monthly rise on record. In fact, they showed a surprising turnaround in year-over-year growth terms, from March's -17.1% to 7.9%—the first rise in ten months (**Display 6**). We will be watching closely to ascertain whether this positive movement in orders is truly sustainable. If so, it would encourage us to consider upgrading our outlook on capital spending and economic growth. The April upturn in orders at small and medium-sized firms could be the result of recent yen weakness against the dollar providing a significant boost to sentiment at small firms, or it could represent some stabilization of recent economic conditions.

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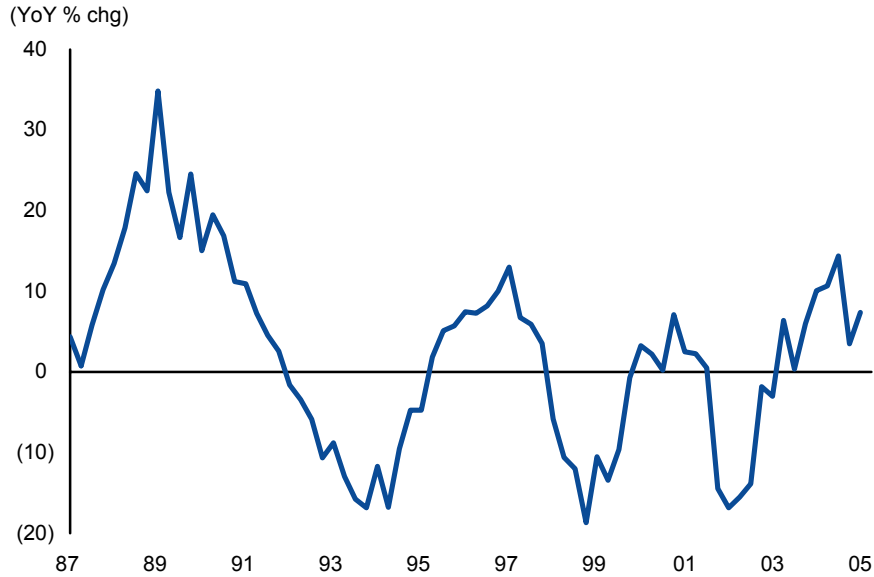
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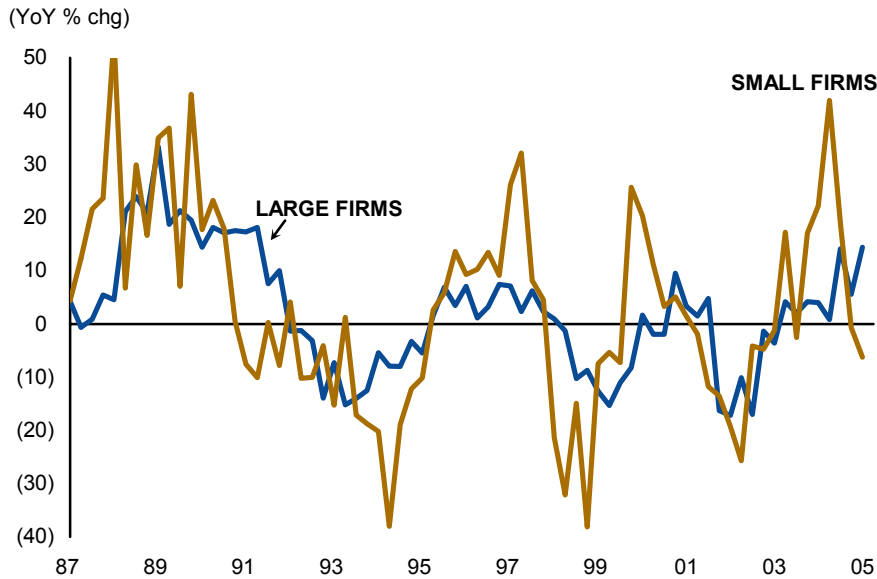
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Display 1: Capital Spending Growth Is Trending Down
 Capital Spending (All Industry)



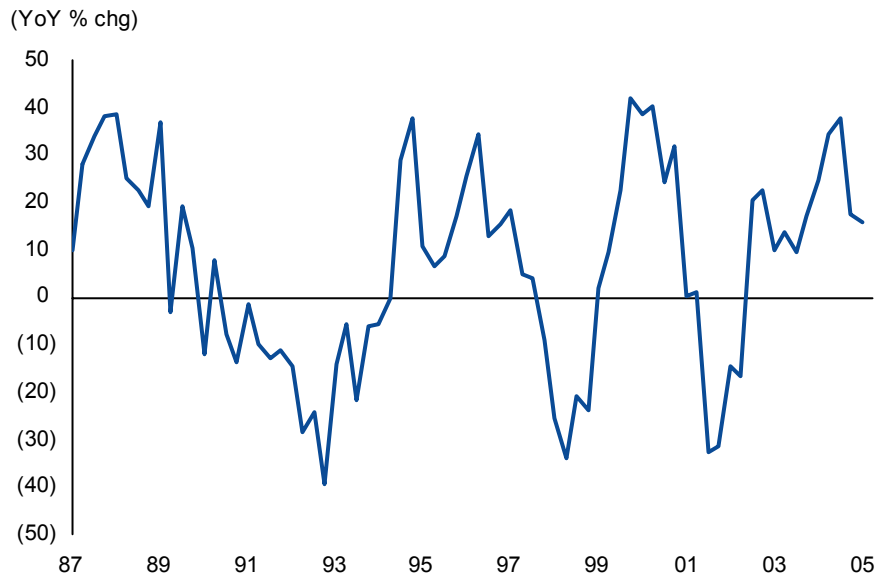
Source: Ministry of Finance: June 21, 2005

Display 2: Capital Spending Trend at Small Firms Usually Leads the Trend at Large Firms
 Capital Spending by Size of Firm



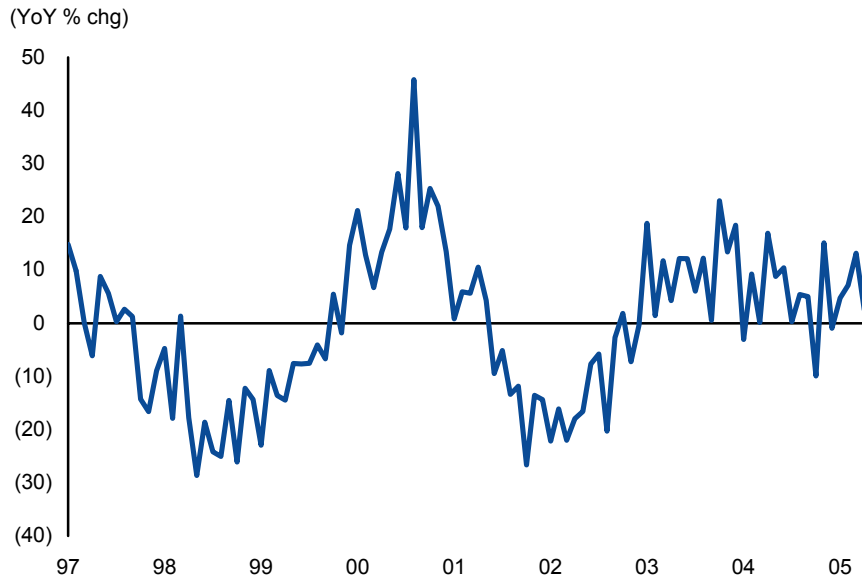
Source: Ministry of Finance: June 21, 2005

Display 3: Growth in Corporate Profits Is Slowing Recurring Profit Growth (All Industry)



Source: Ministry of Finance: June 21, 2005

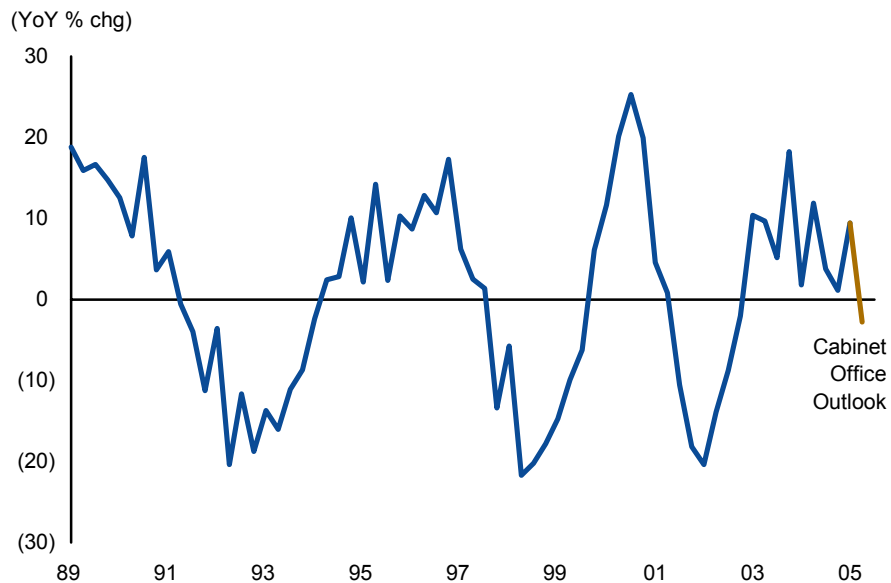
Display 4: Core Machinery Orders Slowed Significantly in April Core Private Domestic Machinery Orders (Excluding Orders from Shipbuilders and Electric Power Companies)



Source: Cabinet Office: June 21, 2005

Display 5: Cabinet Office Predicts Machinery Orders Will Drop in the Second Quarter

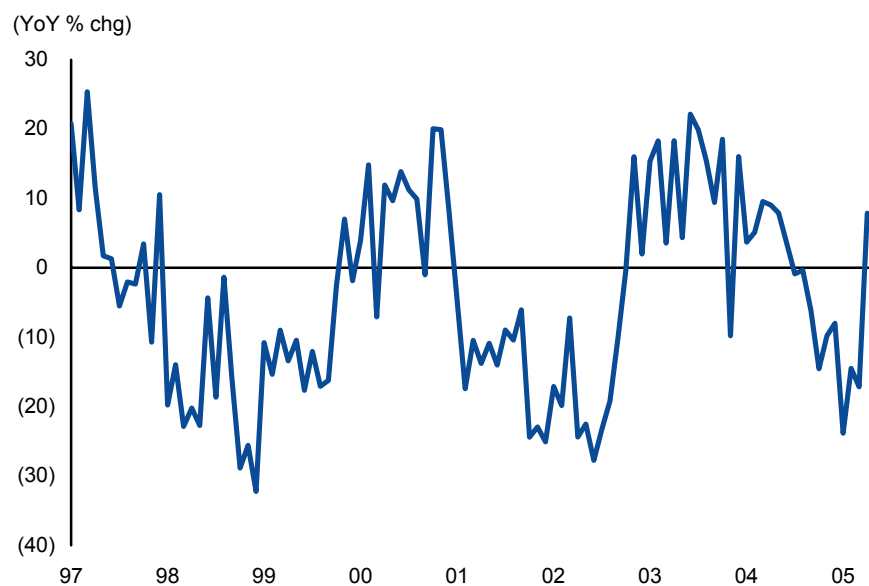
Core Private Domestic Machinery Orders (Quarterly Base)



Source: Cabinet Office: June 21, 2005

Display 6: Sharp Rebound in April Machinery Orders Growth at Small and Medium-Sized Firms Brings Hope to the Outlook

Growth in Machinery Orders from Small and Medium-Sized Firms



Source: Cabinet Office: June 21, 2005