

# JAPAN ECONOMIC WEEKLY



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# Japan Economic Perspectives

## New Data Underscore Capital Spending Weakness

Slowing trends in Japan's sales and profit growth were revealed in the Ministry of Finance (MOF) fourth quarter corporate survey released last Monday. And, although our forecast assumed that capital spending would continue to be a positive contributor to GDP growth in 2005, survey results for spending and inventories together with January machinery orders suggest there are risks to our outlook.

In the corporate survey released by the Ministry of Finance for the fourth quarter, all-industry sales grew at a firm 5.1% year-over-year, albeit slightly below the third quarter's 5.7% (**Display 1**). Broken down by sector, however, a weaker picture emerges. Manufacturing sales slowed sharply to 4.7% down from the third quarter's 7.1%, while non-manufacturing sales growth remained almost unchanged at 5.3%, compared to 5.0% in the third quarter.

All-industry recurring profits declined 2.4% quarter-over-quarter, down for the first time in seven quarters. A more drastic deceleration occurred on a year-over-year basis, as growth fell from 37.8% in the third quarter to 17.6%, the lowest reading in a year. Within this, recurring profits grew 25.3% in manufacturing and 12.4% in non-manufacturing.

Particularly worrisome were results for all-industry capital spending which showed a quarter-over-quarter decline of 2.8%, the first fall in five quarters. Capital spending showed a significant slowdown in year-over-year terms as well, falling from 14.4% of the third quarter to a mere 3.5% (**Display 2**). Small firms in particular (with capital at JPY 10 million to JPY 100 million) declined 0.7% year-over-year, while capital spending at medium-sized (JPY 100 million to JPY 1 billion) and large firms (over JPY 1 billion) saw respective increases of 2.8% and 5.6%.

All-industry inventory statistics in the survey imply that the Japanese economy may be entering a stage which will require a significant inventory adjustment. The remarkable increase in all-industry

inventories, which rose 6.8% year-over-year, was a significant acceleration from the third quarter's 3.8% and the highest reading in nine years. In particular, non-manufacturing inventories shot up sharply to 8.0% versus 4.0% in the third quarter, the highest rise in nine years, while manufacturing inventories saw a moderate acceleration from the third quarter's 3.5% to 4.6%, the highest growth in seven years. These results contradict the industrial production statistics, which showed a 0.4% decline year-over-year (**Display 3**).

Private inventory levels were the chief reason for an upward revision to fourth quarter GDP in the survey results, pushing GDP growth up by more than 0.2% point. Indeed, quarter-over-quarter GDP growth for the quarter was revised up from the preliminary -0.1% quarter-over-quarter (-0.5% SAAR) to 0.1% (0.5% SAAR).

Yet despite improved headline GDP growth, the private capital expenditure component was actually revised down significantly from 0.7% quarter-over-quarter to just 0.1%. Because the private capex revision is a negative for the economic outlook, we maintain our cautious 2005 growth forecast of 0.3%.

## Core Machinery Orders Hint of Capital Spending Weakness Ahead

A decline in core machinery orders in January supports our cautious view on capital spending. Core domestic machinery orders, which exclude shipbuilders and electric power companies, declined 2.2% month-over-month, much worse than the market expectation of 3% growth and follows an 8.8% decline in December. In year-over-year terms, orders rose only 4.8%, which was significantly lower than the Cabinet Office's first quarter outlook of 17.5% (**Display 4**).

Electrical machinery orders, which account for roughly 30% of overall manufacturers' orders were particularly weak, down by 31.9% month-over-month, the largest decline in more than six years. On a year-over-year basis, they were down 30.0%, the largest fall in three years (**Display 5**).

Even more discouraging were machinery orders from small and medium-sized firms (through agencies) which account for roughly half of the capital expenditure in the overall economy. Orders for these firms plunged sharply by 18.9% month-over-month, the largest drop in seven years and by 23.8% on a year-over-year basis, the largest decline in over two and a half years **(Display 6)**.

Finally, foreign orders saw their largest fall in 18 months, declining sharply by 31.0% month-over-month. They rose in year-over-year terms by 10.9%, however, although this was much lower than respective growth in November and December of 34.0% and 18.7%.

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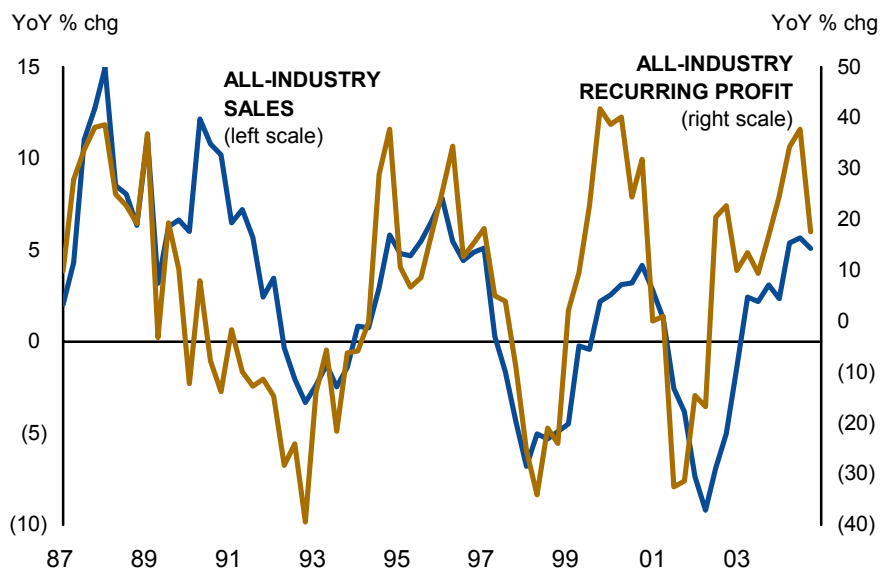
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## Display 1: Recurring Profit Growth for All Industries Slowed Sharply in the Fourth Quarter

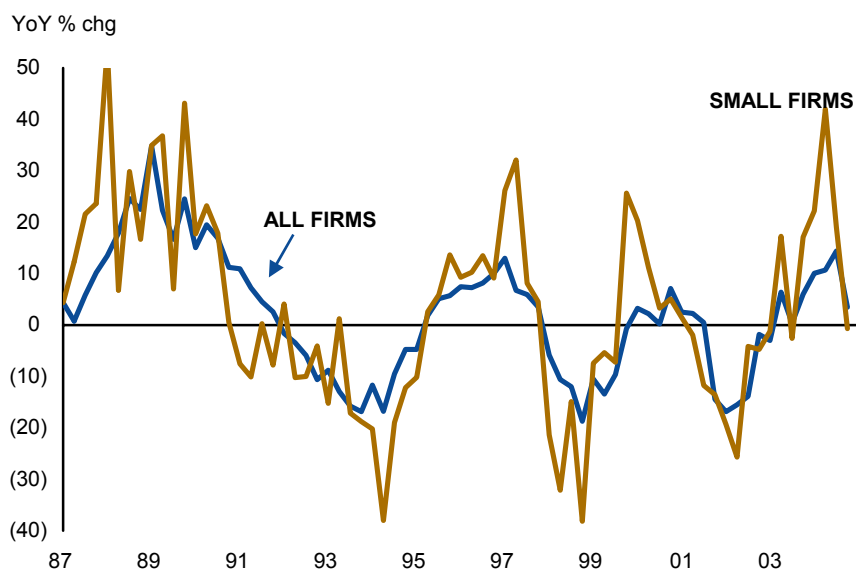
### All-Industry Sales and Recurring Profits



Source: Ministry of Finance, March 15, 2005

## Display 2: Capital Spending Decelerated Significantly in the Fourth Quarter, Particularly for Small Firms

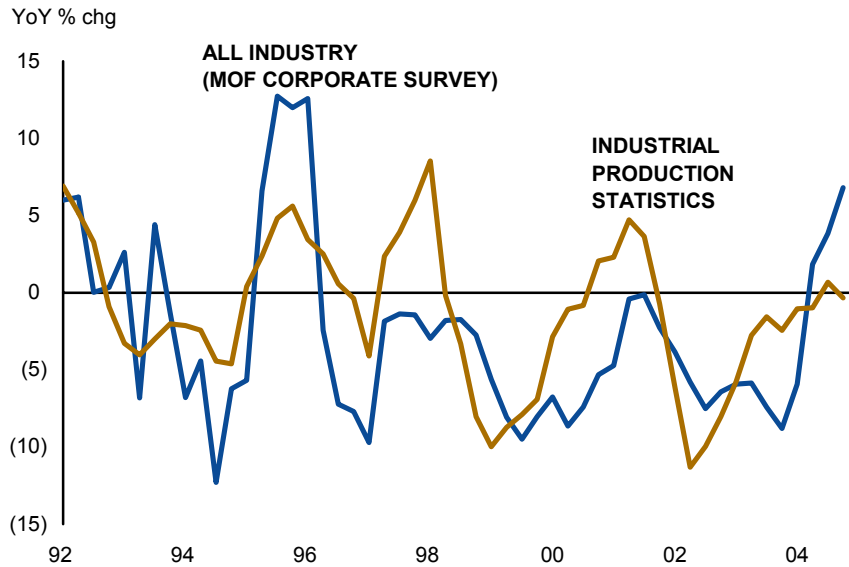
### Capital Spending (All Industry)



Source: Ministry of Finance, March 15, 2005

### Display 3: All-Industry Inventories Shot Up in the Fourth Quarter

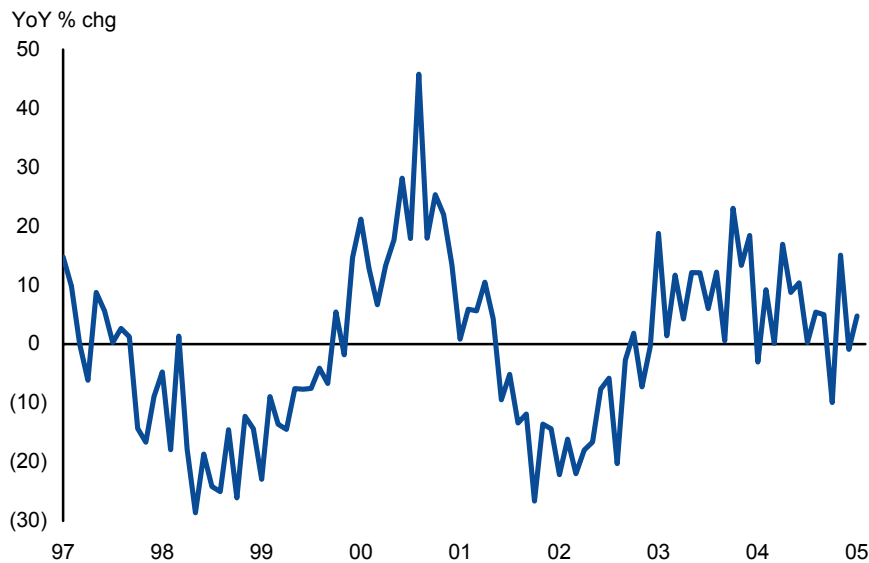
Inventories: Ministry of Finance Corporate Survey vs. Industrial Production Statistics



Source: Ministry of Finance, Ministry of Economy, Trade and Industry, March 15, 2005

### Display 4: January Machinery Orders Disappointing

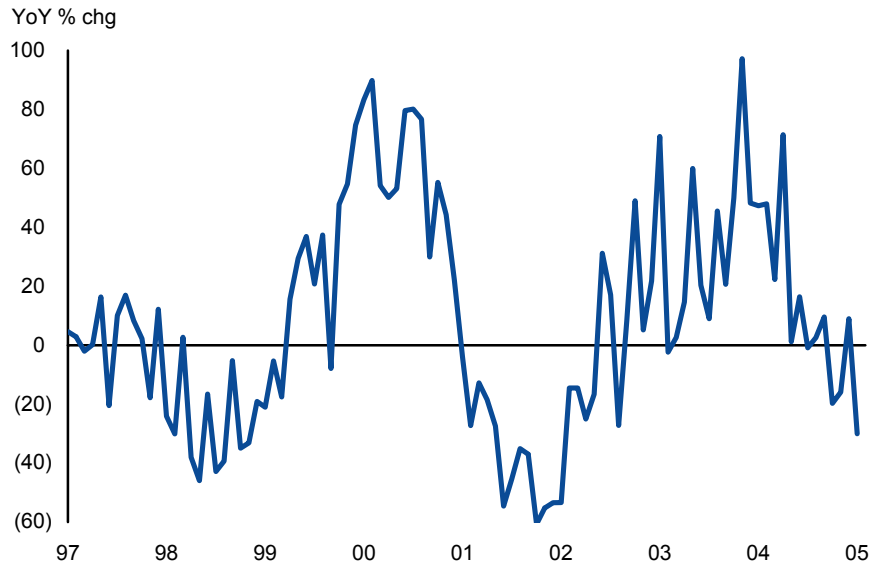
Core Domestic Machinery Orders (Excludes Orders from Shipbuilders and Electric Power Companies)



Source: Cabinet Office, March 15, 2005

## Display 5: Machinery Orders of Electrical Machinery Sector Show Pronounced Downtrend

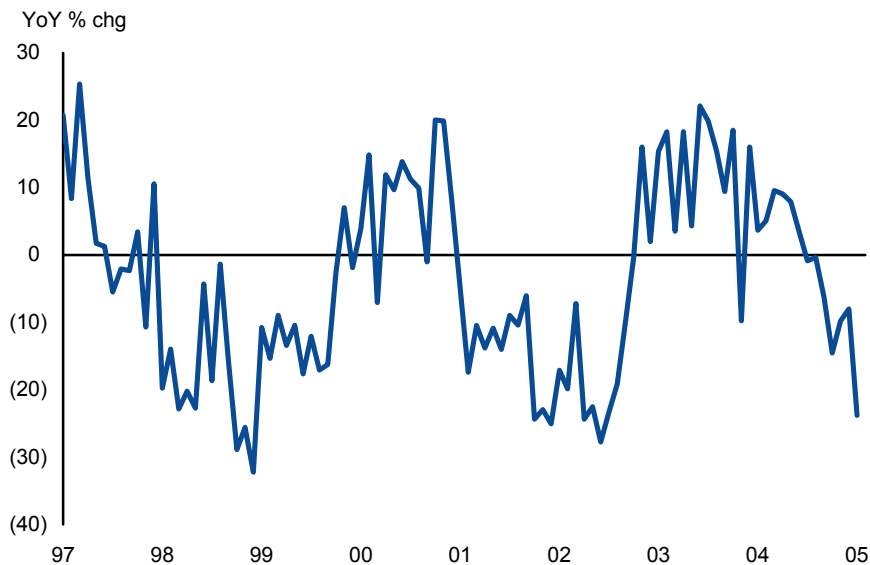
### Machinery Orders of the Electrical Machinery Sector



Source: Cabinet Office, March 15, 2005

## Display 6: Worrisome Downtrend Continues in Machinery Orders of Small and Medium-Sized Firms

### Machinery Orders of Small and Medium-Sized Firms



Source: Cabinet Office, March 15, 2005