

## Japan

### Gloomy Tankan

- The Bank of Japan's short-term economic survey (Tankan) published in March indicates a slowdown in activity in Q1.
- The manufacturing and non-manufacturing sectors were both hit, although for the first, the present conditions index is approaching dangerously close to zero.
- The situation in both sectors is also likely to deteriorate in Q2. The expectations index fell sharpest in the manufacturing sector, however, swinging into negative territory for the first time in ten quarters.

The Bank of Japan's short-term economic survey (Tankan) indicates a slowdown in Q1 activity. Based on a survey of business leaders, the general index of present conditions declined 2 points to 7 (from 9 in December 2015) and is now at the same level as in Q1 2015. Worse, the situation is likely to continue deteriorating in Q2, regardless of the sector: the expectations index contracted by 6 points to 1, the biggest decline since Q2 2011, and the lowest level since Q2 2013.

#### The manufacturing sector runs out of steam

The present conditions index for the manufacturing sector reported the sharpest decline, down 2 points to 1, the lowest level since Q3 2013. The decline in non-manufacturing was not as steep, down only 2 points to 11. Large manufacturing companies reported the biggest decline (-6 points). For small businesses, which account for nearly half of the sector sample, the confidence index did not fall as much (-4 points), but it has now dropped below zero again, after holding in positive territory almost continuously over the past nine quarters. These survey results are in line with the latest sector hard data. In Q1, assuming zero growth in March, acquired growth in manufacturing activity was -1.9% q/q. We have to look back to Q4 2012 to find such a sharp decline in manufacturing output. At that time, GDP contracted slightly (-0.1% q/q). Moreover, the expectations index for the manufacturing sector indicates an ongoing deterioration in the situation. The index dropped to -3, the lowest level since Q2 2013, and the first time it has been in negative territory since Q3 2013.

Confidence in the non-manufacturing sector has also deteriorated. The diffusion index (DI) declined 3 points to 22 for large enterprises, and 2 points to 17 for mid-sized enterprises. For small businesses, which account for more than half of the sample of enterprises in the non-manufacturing sector, the index was down 5 points to 4. The general expectations index for the non-manufacturing sector points to an even sharper decline in Q2. It was down 7 points to 4, the lowest level in the past seven quarters.

#### GDP growth and Tankan

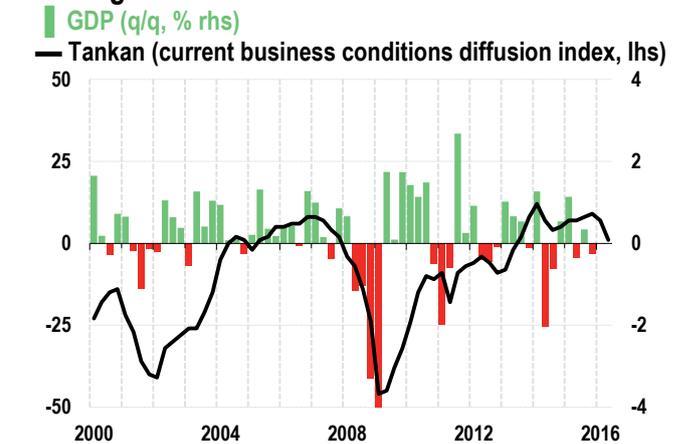


Chart 1

Sources : Bank of Japan, Cabinet office

#### Manufacturing output and Tankan

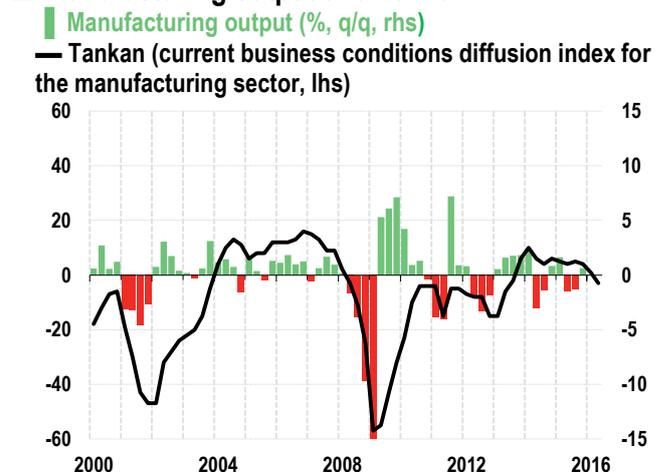


Chart 2

Sources : Bank of Japan, Cabinet office

#### Investment programmes stall early in the year

All of the companies participating in the Tankan survey expected their investment programmes to decline (-4.8%) in fiscal year 2016 (ending 31 March 2017). Once again, small businesses are the most pessimistic: investment is expected to decline by more than 19%. Although this decline might seem alarming at first, there is a good chance that it will be revised upwards over the course of the year, as is generally the case. At the same time last year, all companies expected investment to contract by 5%, but it ended up rising 1.5% in 2015. In terms of R&D investment as a share of GDP, note that Japan ranks third among the OECD countries (more than 3% in 2014, according to the OECD), behind Israel and Sweden. Unlike other countries, companies in the private sector account for the lion's



share of this investment, representing 80% of the amounts engaged (the defence sector accounts for a small portion in Japan, unlike in the United States, for example). The biggest R&D investments are in information technology and telecoms equipment, followed by automobiles, machine tools as well as the chemicals and pharmaceuticals industries. As of the 1980s, measures were introduced to promote private partnerships with universities. Consequently, Japanese companies have developed a culture of placing their actions within a long-term framework. Lastly, the third arrow of Abenomics aims to stimulate private sector investment and innovation by reforming and deregulating traditional sectors (agriculture, machinery and electronics) in order to boost productivity.

Yet these investment programmes still seem very timid compared to the earnings and cash flows reported over the past several years. Moreover, the level of the yen should encourage manufacturing companies to produce locally, which should boost investment and domestic production. It is also worth noting that excess production capacity has been largely absorbed. In the manufacturing sector, the relative DI has fallen back to 4 in Q1 2016 after reaching 36 in Q2 2009, an all-time high since the start of the series in 1974. For the economy as a whole, the companies surveyed considered that they had been slightly short of capacity for the past eight quarters.

**Companies hits by a labour shortage**

According to the Tankan survey, companies are facing a labour shortage. For all companies, the balance between overstaffed and understaffed companies was still about -18, which is nearly the lowest level since Q2 1992, when the jobless rate was 2.3%, compared to 3.3% last February. Job market tensions are strongest in the non-manufacturing sector, where DI dropped to -26, the lowest level since Q2 1992, and should continue to decline in June (-28). For all sectors combined, small and mid-sized companies felt they were particularly understaffed (-20 and -27, respectively) compared to large companies (-11). This is a key trend in so far as small and mid-sized companies employ 70% of the active population. Companies have begun hiring again since late 2013. The job offers to demand ratio rose above 1 in November 2013, signally that job market conditions continue to tighten. In February 2016, this ratio rose to 1.28, the highest level since December 1991, when the unemployment rate was 2.1%. The diffusion index for all companies is expected to decline further in June, to -20 from -18.

The pressures of an aging population, which fuels job offers, are likely to gradually dilute the specificities of the Japanese job market. In the past, employees were fiercely loyal to their employers, who in return virtually guaranteed job security. Changes in Japan's work culture and the labour shortage that seems to be taking shape will lead to greater job market participation by women, youth and seniors. In this respect, Japan's female employment rate has increased 7 points from the 2000 level and is now nearly 6 points higher than the OECD average (63.7% vs. 56%). We can also see the emergence of high paid specialists, to the detriment of multi-skilled generalists, and a new generation of "freeters", independent workers who move between small jobs, temp services and short-term contracts, thereby maintaining their social and financial autonomy.

■ Manufacturing and non-manufacturing sectors  
— Current business conditions diffusion index for the manufacturing sector ; — Current business conditions diffusion index for the non-manufacturing sector

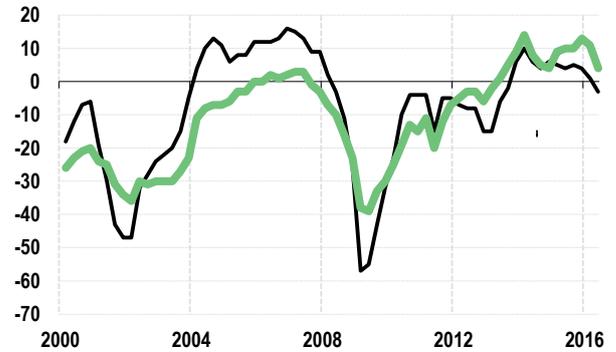


Chart 3 Sources : Bank of Japan, Cabinet office

**Corporate financial situation further improves in Q1**

According to the Tankan survey, for all companies the diffusion index regarding their financial position rose in Q1 2016 to the highest level since Q1 1990.

Even so, companies remain extremely cautious and continue to accumulate liquidity, despite negative financial market conditions. According to Flow of Funds statistics, liquidity and deposits accounted for 22% of total financial assets in Q4 2015, i.e. the equivalent of JPY 246 bn (nearly 50% of GDP), compared to 35% in the 1990s. This sub-optimal use of capital is harmful not only for corporate development, but also for the rest of the economy.