Japanese economic locomotive strays from line

Everyone should know what the "*Tankan*" is. It is the most comprehensive economic survey in the world, carried out each quarter by the Bank of Japan and analyses in detail developments in the Japanese economy.

Nine thousand six hundred and fifty three Japanese firms took part in the latest survey, released this week. Every major firm and 93% of all Japanese firms took part. Thus it is a survey that should never be ignored or underestimated by the financial markets.

The latest survey did not provide happy reading for the Japanese authorities. They hoped it would show the recovery was gathering momentum. It did not. Instead it showed the recovery is mild.

Since last year policy makers have played the key role in boosting the economy. Japan has benefited from a triple stimulus of a yen depreciation, record low interest rates of 0.5% and a huge increase in government spending of £90 billion announced last September.

This year, the main economic question in Japan has been what will happen when the impact of last year's policy easing fades away? Will the private sector take up the slack? The answer from the *Tankan* is no. The private sector remains weak.

The biggest shock from the survey was that confidence among the largest manufacturing firms fell, as demand at home and overseas remained weak. A large number of these firms still have excess workers and inventories. This suggests that economic conditions will remain tough.

Not everything was pessimistic. There was an improvement in confidence among small firms and larger firms not involved in manufacturing. But in all of these categories there are still more firms who regard conditions as "unfavourable" than "favourable".

The Bank of Japan was quick to stress that firms are not fully taking into account the weaker yen. If they did, confidence would be higher as large firms can make profits around Y:$98 and small manufacturing firms break even around Y:$101. The yen has been hovering around its current level of Y:$108 for some months. Yet firms are slowly adjusting to a weaker yen. In the survey carried out in February firms expected a rate of Y:$98.12. Now they are basing their plans on Y:$102.23.

A main explanation for low business confidence is that the Japanese economy is experiencing a big structural shift. Just as firms in Britain and elsewhere have been cutting costs, so too have those in Japan. In addition, they wish to locate production close to future final demand. The clearest reflection of this has been a shift in production to lower cost centres elsewhere, particularly in South-east Asia.

The latest *Tankan* showed that a bigger slice of investment and production by large Japanese manufacturing firms is taking place outside Japan. Overseas production is set to rise by 13% this year and will account for 22.2% of all production. The corresponding figures for investment are higher, with almost one-third of all investment set to take place outside of Japan.

As well as this deindustrialisation, there is pressure to deregulate and open up the economy.

One consequence has been a shift towards the service sector. Another has been a dramatic decline in Japan's trade surplus. Imports have risen steadily, although many of these are from Japanese subsidiaries overseas.

A casualty has been small firms. In previous cycles small firms would have led the recovery, but not this time. Lacking the financial resources of large firms, small firms have not been able to shift production offshore. They have had to stay in Japan and compete. Consequently, small firms have shed excess workers. By contrast, large firms have not cut workers as much as they should. One in four people are employed as lifetime workers by large firms. According to the *Tankan*, a net 19% of these large firms have "excess workers". Thus there is still some uncertainty about job prospects, even though wages are now recovering and jobs are being created in the service sector.

What does the *Tankan* mean for policy? With the economy continuing to grow below trend and no inflation in sight, an early increase in Japanese interest rates is ruled out. This will be despite continued criticism of low interest rates from Japan's many pensioners and savers. In Japan there is political pressure for the Government to raise interest rates ahead of the general election, which is due by next summer.

The latest *Tankan* will add to pressure for the government to unveil another big spending boost, despite its poor budget deficit. This has not deterred Japanese investors from buying bonds, which have been the main beneficiary of the *Tankan* because of the prospect of continued low interest rates.

By contrast, the Japanese stock market has fallen since the latest *Tankan* despite the prospect of a further rise in corporate profits because of cost cutting. The stock market has had a strong rally over the last year and the survey provided no fresh impetus to buy. Instead, it left the stock market exposed to worries about forthcoming supply.

Consequently, Japanese investors remain risk-averse.

Faced with continued low yields at home they should invest more overseas, but there is still no guarantee they will. Like the Japanese government, they will keenly await the next *Tankan* survey in three months time.

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Japan's economy is recovering but only at a modest pace and a weak private sector has left the authorities concerned, says **Gerard Lyons.**