

Japan

PMI slides into contraction, but increased hiring and rising demand for investment goods point to short-lived impact from sales tax rise

- **Manufacturers report steep falls in output and new orders in wake of sales tax rise**
- **Stronger job creation and demand growth for investment goods such as plant and machinery suggest downturn will be temporary**

Manufacturing activity deteriorated in April, as production and new orders dropped sharply in the wake of the sales tax rise. The headline Markit/JMMA Manufacturing PMI registered one of the largest monthly falls on record, down from 53.9 in March to 49.4 in April. The latest reading signalled the first deterioration in manufacturing business conditions since February last year.

With the exception of the disruption caused by the March 2011 tsunami, the decline in the PMI and the survey's output and new orders indices were among the largest since late-2008, when the country was gripped in the aftermath of the Lehman's collapse.

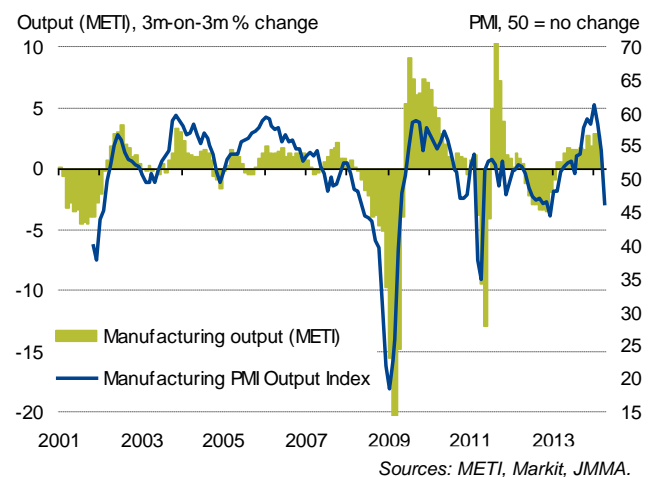
The downturn represents a poor start to the second quarter, with the PMI sub-indices running at levels broadly consistent with manufacturing output – a major contributor to gross domestic product – contracting at a quarterly rate of 3% in April.

This time, according to anecdotal evidence provided by survey panel members, the cause of the deterioration was the April 1st increase in Japan's sales tax from 5% to 8%. Production and new orders had risen sharply in prior months, with output growth hitting a new survey high at the start of the year, as consumers brought forward expenditure ahead of the tax hike. Pay-back after the tax rise was always on the cards. The question is: how long will it take for growth to revive again?

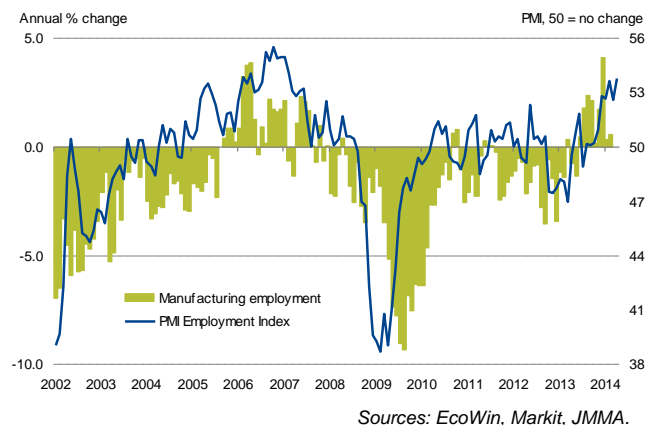
Temporary slowdown

There are several indices which suggest the downturn will be brief. Most importantly was the increase in hiring recorded by the PMI survey in April. The rate of job creation accelerated to the highest since February 2007, with companies often citing expansion plans and

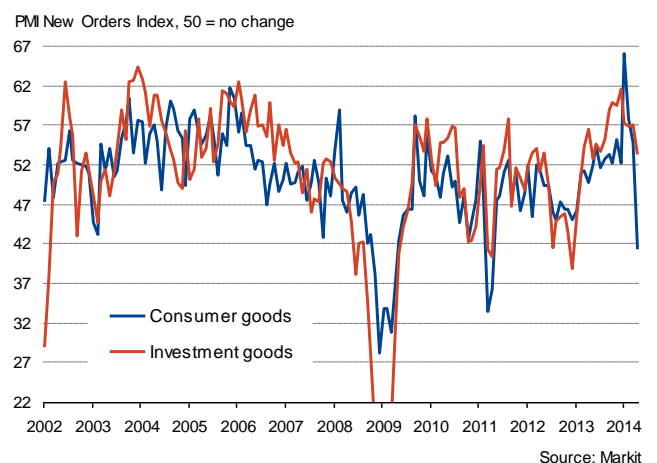
Manufacturing output



Manufacturing employment



Consumer and investment goods



the anticipation of robust underlying demand as the main reasons behind higher headcounts.

Secondly, the downturn in output and order books was most pronounced in the consumer goods sector (with the latter seeing the strongest growth among the three categories in the first three months of the year). In contrast, production and new orders for investment goods such as plant and machinery continued to rise, albeit at reduced rates compared to prior months (though many so-called investment goods are also purchases as consumer items, notably autos).

Encouragingly, employment rose in the consumer, intermediate and investment goods categories, adding to the sense that all sectors are expecting stronger demand in coming months.

The ongoing growth of demand for plant & machinery and staff suggests that manufacturers firmly remain in expansion mode. However, it is likely that the economy will see a slowdown in the second quarter.

Export performance and lower equity prices to cap economic growth

The extent to which growth will rebound may also be curbed by weak export growth. April saw new orders from abroad for manufacturing goods decline, albeit modestly, for the first time since last August. Weak demand from other Asian countries, notably China, appears to lie behind much of this weakening.

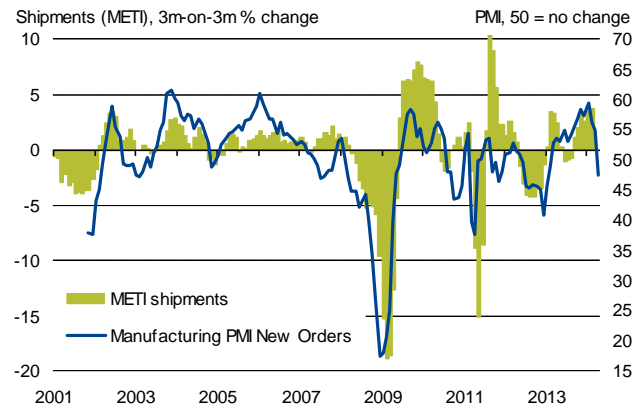
A further factor which could limit growth after the impact of the sales tax has passed is the recent fall in share prices. As explored [last month](#), the PMI is closely correlated with Japanese share prices, and the damaging wealth effect of the 12% fall in equity prices so far this year could also stymie economic growth. While we expect the economy to recover from the initial impact of the sales tax rise, the pace of growth is likely to be disappointingly modest.

Chris Williamson
Chief Economist

Markit
Tel: +44 207 260 2329
Email: chris.williamson@markit.com

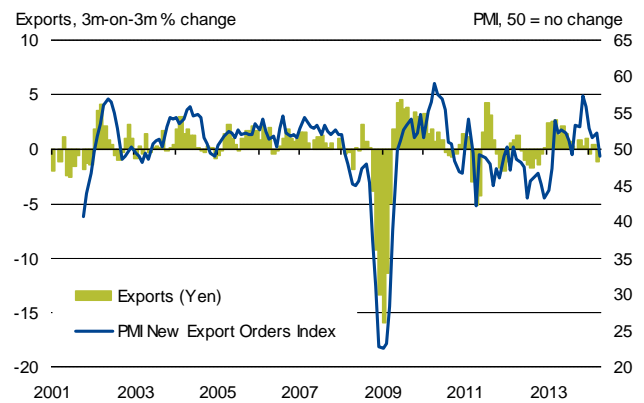
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Manufacturing shipments



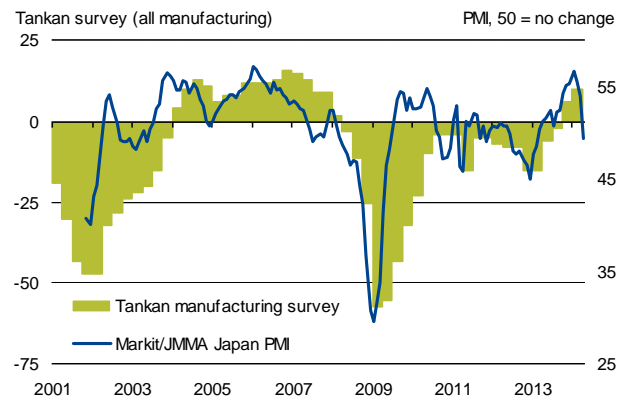
Sources: METI, Markit, JMMA.

PMI and exports



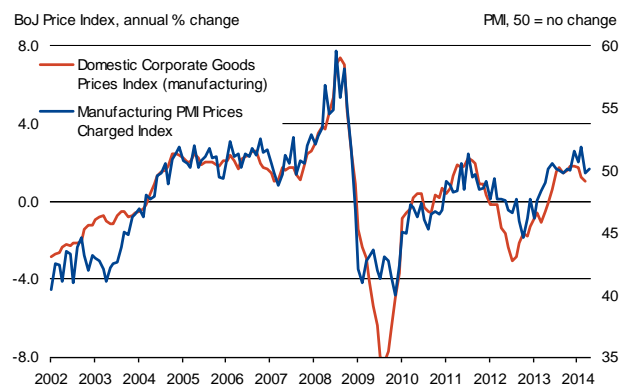
Sources: EcoWin, Markit, JMMA.

PMI v Tankan



Sources: EcoWin, Markit, JMMA.

Factory gate prices



Sources: BoJ, Markit, JMMA.