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Markit Economic Research

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Japan

PMIs suggest economic growth to continue into third quarter

- **PMIs signal a modest revival of business activity growth in August**
- **Manufacturing output expands at quickest pace since February 2011, despite weaker exports**
- **Yen's depreciation adds to corporate worries by raising import costs**

The latest PMI data indicated a recovery of growth momentum in August, following July's brief lull. However, not all the signals were positive and it remains to be seen if Prime Minister Shinzō Abe's policies, dubbed 'Abenomics', are generating a long-term economic recovery and beating deflation.

Private sector output increased for the eighth consecutive month according to Markit's August PMI surveys. The all-sector Output Index rose from July's five month low of 50.7 to 51.9, consistent with only modest growth but nevertheless representing a welcome re-acceleration of the growth rate.

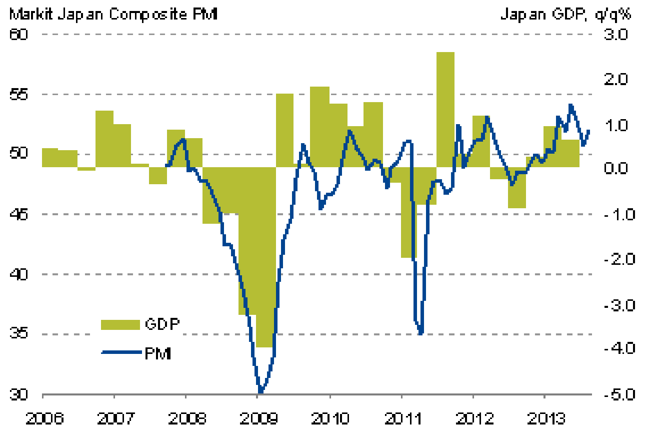
The latest PMI data therefore bode well for economic growth in the third quarter after the worries associated with July's slowdown, especially given its broad-based nature. The service sector recorded only a modest improvement, albeit better than July, while the manufacturing industry reported a more robust increase, expanding at the quickest pace seen in two and a half years.

PMI data indicate that GDP for the third quarter may rise at a similar rate to the 0.6% expansion seen in the second quarter, though much depends on how businesses fare in September and whether global demand picks up enough to aid Japan's exporters.

Exporters struggle despite weak yen

A renewed fall in exports, the first decline for six months, indicated that the benefits of the yen's depreciation are being offset by weak demand in key foreign markets. Survey indicators of new order growth nevertheless picked up for both manufacturing and services, pointing to a modest upturn in domestic demand.

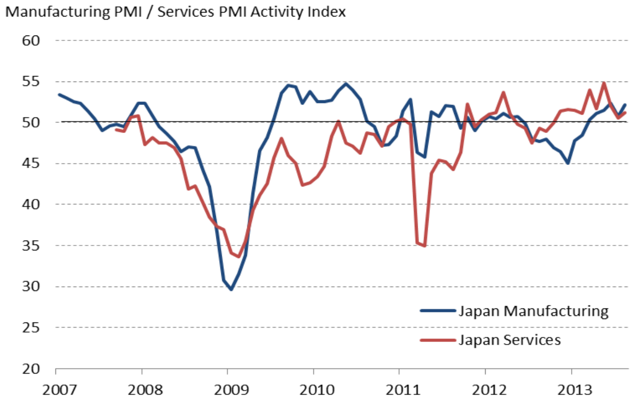
Markit/JMMA Japan 'all-sector' PMI and GDP



Sources: Markit, Cabinet Office (via Ecowin)

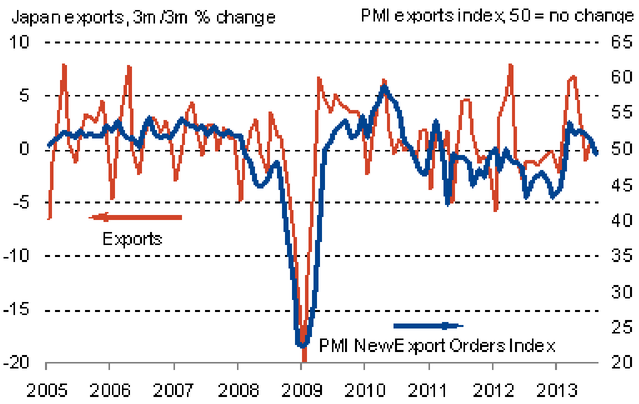
PMI Business Activity Indicators

Manufacturing PMI / Services PMI Activity Index



Sources: Markit

Exports



Sources: Markit, Cabinet Office (via Ecowin).

Monetary easing has resulted in the yen falling nearly 25% against the US dollar since Prime Minister Abe's election in November of last year. This should have expanded demand for Japanese exports. However, as a result of the contraction in global demand, the survey data suggest that the benefits of improved price competitiveness are not translating into higher foreign sales, with many companies blaming the disappointing performance on weak demand in key foreign markets, notably China and the Eurozone.

Costs rise, but selling prices fall

Rising input costs also remain problematic for firms in all sectors and Japan's dependency on imported energy has caused spiralling fuel costs for many businesses. Costs rose for the ninth successive month in August, led by manufacturers' input costs rising at the fastest rate for almost two years.

Companies reported that the weak yen is driving up input costs by raising the price of imports. This issue is exacerbated by the recent switch in Japan's main energy sources. Following a series of power plant closures, initiated by the earthquake in March 2011, Japan now relies almost entirely on imported energy, particularly natural gas from Australia and the Gulf. As a result, firms are much more vulnerable to exchange rate fluctuations and the huge increase in fuel imports has caused the current trade deficit. It is likely that the dependency on foreign fuel has been a key driver of the sharp cost inflation seen this year, which has limited exporters' ability to benefit from the weak yen as their margins have been eroded by higher input costs.

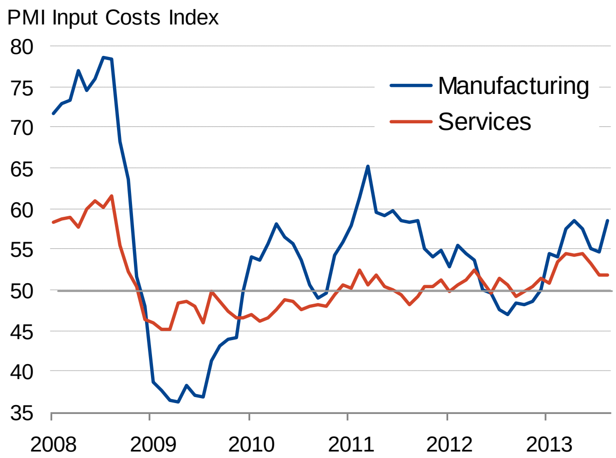
Cost-driven inflation diminishes firms' profits, which means rising prices fail to translate into higher wages and increased demand. The latest PMI data confirms that this may well be the case in Japan, because despite consistent and solid increases in input prices since January, prices charged for goods and services have fluctuated between decline and stagnation, with a further modest fall recorded in August.

Anecdotal evidence from respondents indicated that pressure to cut prices remained intense amid weak demand and resistance to price rises from customers.

Sales tax worries hit confidence

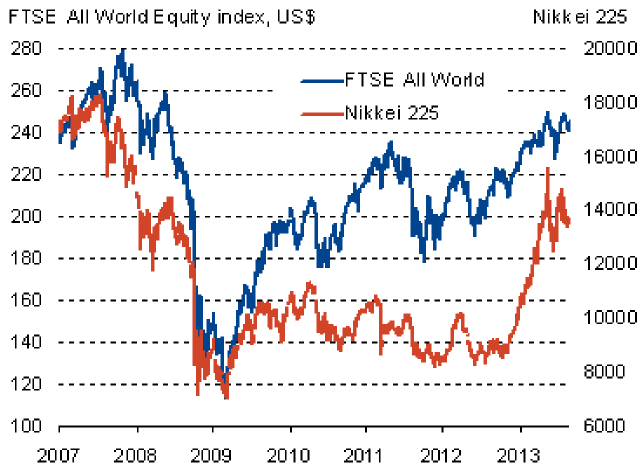
Abe's commitment to quantitative easing until inflation reaches 2% has had a clear impact on Japanese equity prices, which have risen steeply since his election in November 2012. However, demand-driven inflation requires structural reforms, and the latest PMI data suggests businesses have grown less confident in the government's handling of the economy. Whilst service providers remained optimistic on the whole, business sentiment fell for the third consecutive month in August, to the lowest level recorded since November 2012. A number of panellists qualified their positive responses with the caveat that they only expect an improvement in business activity in the coming year if the sales tax rise is postponed.

Input costs



Sources: Markit

Equity prices



Sources: Ecowin

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