

# Japan

## Economy enjoys strong end to third quarter as growth accelerates in September

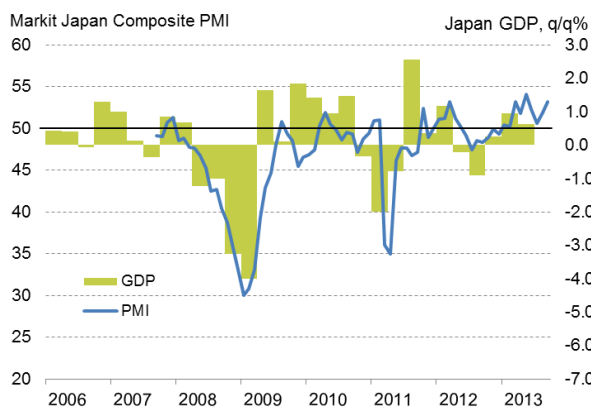
- **Composite PMI hits four month high**
- **Both services and manufacturing expand**
- **Weak employment growth and falling real incomes raise questions over outlook**

A broad-based expansion of private sector activity was signalled by the latest PMI data, as business activity increased at a solid pace at both manufacturers and service providers in September, rounding off a strong third quarter.

Other indicators told a less positive story however. Private sector employment growth slowed to near-stagnation, whilst service providers' order books also failed to grow in September, hinting at weak domestic demand. In addition, with the recent confirmation of the sales tax hike next April, price inflation and weak pay growth pose a risk if they persist.

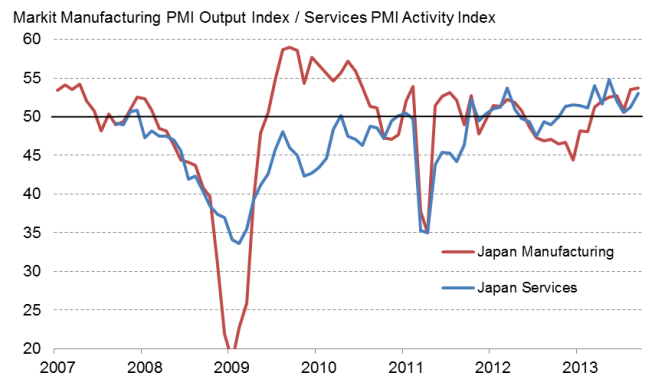
Business activity expanded for a ninth successive month in Japan's private sector according to Markit's September PMI surveys. The all-sector Output Index rose from 51.9 in August to a four-month high of 53.2. Although down from the record highs seen in the second quarter, the average reading for the three months to September was one of the strongest in the survey's history. This suggests third quarter economic growth may come in only moderately weaker than the 0.9% increase seen in Q2.

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



Sources: Markit, Cabinet Office (via Ecwin)

### PMI Business Activity Indicators



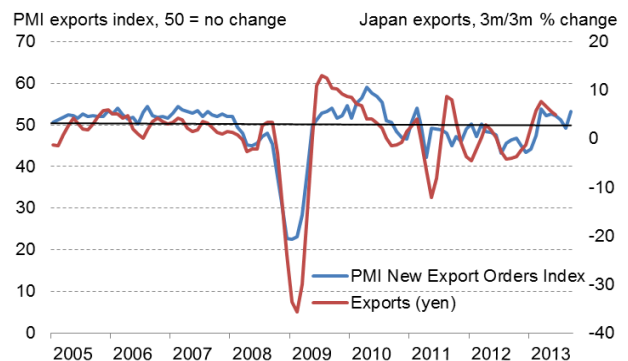
Sources: Markit

[Manufacturing](#) production rose in September at the fastest pace since February 2011, with new order growth at a 40-month high. Consequently, output growth in the third quarter was the strongest for just over three years. The service sector signalled similarly solid growth, though July's weak reading lowered the third quarter average.

### Export growth hits 6-month high

Prime Minister Abe's policy of monetary easing caused the yen to fall nearly 25% against the US dollar since his election in November 2012, and manufacturing export orders, aided by the weak yen, increased at the fastest pace since March. However, it is likely the most recent increases in exports were also partly the result of expansions in foreign demand.

### Exports



Sources: Markit, Cabinet Office (via Ecwin).

## Private sector doubt over growth longevity

Despite the strength of September's business activity growth, other indicators revealed firms' doubts over the sustainability of the current expansion.

In particular, a broad stagnation of employment has been registered across the private sector over the last three months. The absence of recruitment betrays an overall lack of business confidence: firms will only commit to recruiting when they anticipate a need for staff beyond the near-term.

## Consumer demand wavers

Other indicators suggest consumer confidence may also need support as demand may be insufficient to sustain the current level of growth. In particular, new orders have stagnated at service providers for three consecutive months, and much of the activity in the sector appears to have been driven by a depletion of backlogs rather than new demand. Without a rise in new orders, the current pace of growth will be hard to sustain.

## Cost-inflation continues, risking erosion of real wages

A potential cause of weak consumer demand is cost-inflation resulting from the policies of the government. Whilst the prime minister has successfully achieved his target of stimulating inflation, it has not been demand led but rather pulled upwards by costs.

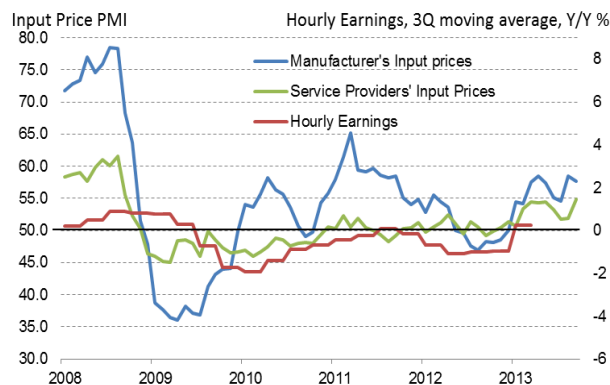
Prices charged in Japan's private sector didn't rise in September, though input prices did. This implies that customers are perceived as too responsive to price rises for firms to risk passing on increased costs. There are many possible factors which could be behind this, but given the stagnation of wages, one underlying cause may be the decline in disposable incomes caused by cost-inflation.

The combined forces of the weak yen and a new reliance on imported energy following the decommissioning of Japan's nuclear power plants have greatly increased import costs for firms and consumers alike. This has caused the price level to rise, with some companies, such as Yakult, increasing their RRP's for the first time in two decades. Whilst inflation is preferable to deflation, the latest available data indicates the price level is accelerating away from wages. As this continues, consumers' purchasing

power and therefore consumption is eroded and demand may weaken.

The graph below illustrates the decoupling of hourly wages from inflation. The sharp increases in input prices for private sector firms have been largely caused by the weak yen and rising energy costs which have had similar impacts on consumers.

### Input-Costs and Hourly Wages



Sources: Markit, Bank of Japan

## Abe's ¥5 trillion stimulus

The prime minister's recent announcement that he will go ahead with the sales tax increase in April 2014 may impede growth in the short term. However, the tax will be preceded by a five trillion yen stimulus package with which Abe hopes to boost consumption and help lead to sustainable growth. This government spending will hopefully provide a boost to business activity, which should go some way towards tackling the stagnation in wages.

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