JRI news release

Structural Changes in Capital Investment Behavior and the Prospects for Full-Scale Economic Recovery

— A "jobless recovery" with capital investment firm on a real basis but weak on a nominal basis —

September 11, 2003

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Overview

The April-June quarter of 2003 saw real capital investment increase for a fifth straight quarter, rising 4.7% on the same quarter in 2002 (equivalent to annualized growth of 20.2%). This article analyzes the characteristics of the present recovery in capital investment and considers whether or not the growth of capital investment will lead to full-scale economic recovery.

The present recovery in capital investment fits the "formula" of past recoveries, whereby a recovery in exports leads to an improvement in business profits, which leads to a rise in capital investment. Given that exports are expected to see continued growth, it is likely that the recovery of capital investment will become increasingly clear, especially in the manufacturing sector.

However, it should be noted that the present recovery differs from past recoveries in three ways:

(i) A gap between nominal and real capital investment: Although capital investment continues to grow steadily on a real basis, the pace of the recovery is only mild on a nominal basis. This is due to a significant fall in the capital investment deflator.

(ii) Recovery against a background of low capacity utilization ratios: real capital investment has entered a recovery phase in spite of capacity utilization ratios remaining low.

(iii) Economic trend in phase with indicators: in the past, the trend of production has been virtually synchronous with the economic trend, and capital investment has usually entered a recovery phase around six months after

production has bottomed out. In the present recovery, capital investment began to recover at virtually the same time as production bottomed out.

The basic reason for these “3 changes” in the pattern of recovery in capital investment is that the emphasis in the capital investment behavior of Japanese companies has shifted from “quantity” to “quality”.

(i) The share of IT-related investment has risen: with a view to boosting productivity, improving production processes and increasing the efficiency of distribution, Japanese companies are focusing on IT-related investment.

(ii) A focus on high-return business areas and high-performance equipment: companies are focusing the structure of their business on areas giving a high return, and restricting investment to high-performance equipment in those areas.

(iii) An increase in disposal of equipment: companies are scaling back their involvement in mature and receding industries whose market share has been eroded by imports from Asia, etc. and consolidating or disposing of equipment relating to these industries.

The shift in the pattern of investment behavior towards “quality” has led to “polarization” in capital investment. This is a direct polarization between “growth industries and companies” and “receding industries and companies”. By sector, the pattern that is one of steady investment in manufacturing sector vs. sluggish investment in the non-manufacturing sector.

What is needed to resolve this “polarization” and allow a wider recovery of capital investment is a full-scale recovery of business results in the non-manufacturing sector. This depends on a rise in consumption, which is the “largest source of

domestic final demand", and one possible scenario is a recovery in the profits of the manufacturing sector → employment and wages growth in manufacturing → a rise in consumption → higher profits in the non-manufacturing sector → growth of capital investment, employment and wages in the non-manufacturing sector → a further rise in consumption.

However, the recovery of profits in the manufacturing sector depends to a great extent on cutting personnel expenses, with the consequence that employment and wages conditions in manufacturing are unlikely to see any substantial improvement in the near future. Moreover, manufacturing productivity is far lower in Japan than in the United States, and if the introduction of high-performance equipment, investment in IT and disposal of existing capital equipment currently in progress are to boost productivity, it is likely that employment in the manufacturing sector will continue to fall in the medium term.

In the light of this analysis, it seems probable that the recovery in capital investment will become firmly established but that the pattern of "steady investment in manufacturing sector vs. sluggish investment in the non-manufacturing sector" will persist against a background of firm real capital investment and sluggish nominal capital investment. This suggests that, in a climate of continued deflation, the recovery of confidence in the economy will be limited, especially in the non-manufacturing sector, and that the pattern of recovery will be a "jobless" one, i.e. that employment conditions will be slow to improve. This was the case in the two recovery phases since the collapse of the bubble economy, and it is undeniably possible that a slowdown in foreign economies, for example, will also bring the present recovery to an untimely end.

To be sure of taking advantage of this third chance of full-scale economic recovery, it is essential that Japan make a renewed effort to transform its industrial structure and make all possible haste in building a stronger economic constitution, capable of withstanding external shocks. These efforts will have a significant impact on the chances of economic recovery led by capital investment continuing in fiscal 2004 and onwards.

The government should not only slacken the reins of policy intervention on the grounds that the economy is on course for recovery, but should recognize anew that "strengthening the industrial infrastructure is the first priority of government policy", and make a resolute effort to redistribute fiscal funding to research & development and growth areas, to deregulate, and to cut business taxation.