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BOJ December 2017 Tankan Survey

Manufacturing industry business sentiment improves, reaches most positive level since December 2006

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Summary

- In the BOJ December 2017 Tankan survey of corporate sentiment, the current trend in business sentiment for large corporations in all industries was mixed for both the manufacturing and non-manufacturing industries. However, looking at business conditions DI in a comprehensive manner, corporate business sentiment in Japan continues to be positive. Especially notable is a step up in improvement of business sentiment in the manufacturing industry supported by the weak yen and improvement in exports. We see Japan's economy continuing moderate growth and the December BOJ Tankan survey moves along the same lines as our evaluation.
- The business conditions DI for large manufacturers grew to +25%pt in comparison with last survey's +22%pt, while at the same time exceeding market consensus at +24%pt. Overseas economies continue to recover, and the positive effects of a weaker yen have brought continued growth in exports and production, bringing the fifth consecutive quarter of improvement. Business conditions DI for large non-manufacturing industries marked time at +23%pt (also +23%pt on the previous survey). Performance dropped slightly below market consensus at +24%pt.
- The FY 2017 capex projection for all enterprises in all industries (incl. investment in properties, but not investment in software and research & development) is +6.3% y/y, exceeding market consensus (+5.5%). Looking at the performance of large enterprises by industry, we see that capex projections of manufacturers for FY2017 are up by +10.2%, while large enterprises in non-manufacturing are at +5.8%. This is more or less along the lines of past revisions.
- Employment conditions DI for corporations of all sizes in both manufacturing and non-manufacturing declined (supply/demand becoming tighter). The sense of a shortage of manpower is increasing amongst corporations. Employment conditions DI are expected to decline further in the future for both manufacturing and non-manufacturing centering on small and medium-size corporations, with the condition of the labor market expected to become increasingly tight. Although the tight labor market is a reflection of a good economy, the other side of this situation is that some industries are seen facing difficulties in acquiring the employees they need in the near future. Constraints in the supply of labor may become a drag on economic recovery in the future.

Japanese corporate business sentiment continues its positive tone

In the BOJ December 2017 Tankan survey of corporate sentiment, the current trend in business sentiment for large corporations in all industries was mixed for both the manufacturing and non-manufacturing industries. However, looking at business conditions DI in a comprehensive manner, corporate business sentiment in Japan continues to be positive. Especially notable is a step up in improvement of business sentiment in the manufacturing industry supported by the weak yen and improvement in exports. We see Japan's economy continuing moderate growth and the December BOJ Tankan survey moves along the same lines as our evaluation. The BOJ Tankan supports the central bank's economic assessment of "moderate expansion". As for future monetary policy, the focus is likely to remain the direction of inflation lacking in strength rather than the favorable real economy.

The business conditions DI for large manufacturers grew to +25%pt in comparison with last survey's +22%pt, while at the same time exceeding market consensus at +24%pt. Overseas economies continue to recover, and the positive effects of a weaker yen have brought continued growth in exports and production, bringing the fifth consecutive quarter of improvement. Business sentiment is now at its highest since December 2006 when it was at +25%pt. In addition to the processing industries, there were notably major improvements in business sentiment in the basic materials industries, which have been weighted down by the effects of high crude oil prices since summer.

The basic materials industries improved for the seventh consecutive quarter to +26%pt in comparison to the previous survey (+21%pt). In addition to some industries being dragged down by the high price of crude oil since summer, business sentiment in the basic materials industries was found to lack teeth on some private sector surveys, leading to a slight worsening on the current survey. However, due to continued improvement for profits, the basic materials industries still managed come in higher than the processing industries.

As for performance of individual industries, nonferrous metals, petroleum & coal products, iron & steel, chemicals, and ceramics, stone & clay products experienced improvements. As for nonferrous metals, iron & steel, chemicals, materials prices (sales prices) have been increasing, and the improvement in profits is thought to have contributed positively. As for petroleum & coal products, the increase in the price of crude oil since summer is thought to have contributed to pushing up results. On the other hand, business sentiment marked time for textiles and pulp & paper, and worsened for lumber & wood products.

The processing industries saw improvement in business sentiment for the sixth consecutive quarter at +25%pt in comparison to the previous survey's +23%pt. As for performance by industry, business conditions improved notably for production machinery, shipbuilding & heavy machinery, etc., and processed metals. As for production machinery, both exports and production have been favorable, providing a tailwind. As for shipbuilding & heavy machinery, etc., notable improvement has been seen in orders received, acting as a plus to business sentiment. On the other hand, motor vehicles improved somewhat, while electrical machinery marked time. The weak yen was a plus for motor vehicles, but improperly conducted vehicle inspections worked negatively.

Business conditions DI for large non-manufacturing industries marked time at +23%pt (also +23%pt on the previous survey). Performance dropped slightly below market consensus at +24%pt.

Looking at performance by industry, improvements in business conditions DI was seen in goods rental & leasing, information services, electric & gas utilities, wholesaling, transport & postal activities, and retailing. Information services appeared to gain continued benefits from favorable systems investment by corporations. As for retailing, the increase in the number of foreign tourists visiting Japan and the alleviation of bad weather conditions worked as pluses for the industry. Moreover, improvement in

business sentiment also appears to have been helped out by consumption of high-priced items supported by stock price highs.

On the other hand, business conditions DI marked time for communications, while worsening for services for individuals, accommodations, eating & drinking services, services for businesses, construction, and real estate. As for services for individuals and accommodations, eating & drinking services, the increase in personnel expenses accompanied by the shortage in manpower appears to have had a negative effect. Meanwhile, construction and real estate maintained a high level of business conditions DI due to favorable demand and low interest rates, but worsened on the current survey. Even so, the basic business environment for these industries is expected to continue to be favorable.

Cautious stance continues, but no need for excessive concern

Looking at the future outlook for business conditions DI, large enterprises in the manufacturing sector are expected to be at +19%pt (a worsening of -6%pt in comparison to the current survey), while large enterprises in the non-manufacturing sector are seen at +20%pt (worsening by -3%pt in comparison with the current survey). This shows that corporations remain cautious regarding the future. This is due to the increase in geopolitical risk in the East Asia region associated with the North Korea problem, and the sense of uncertainty brought on by unknowns related to the policies of the Trump administration. In addition, there have been the effects of higher crude oil prices since summer. Meanwhile, regarding the manufacturing industry, another aspect is the reaction to the previously high pace of improvement. However, the BOJ Tankan has had the tendency recently to announce cautious outlooks. Hence this should not cause overly much concern.

Both domestic and in overseas supply & demand conditions improve

As for the domestic supply & demand conditions for products and services DI of large enterprises, the manufacturing industry showed improvement for the fifth consecutive quarter, while non-manufacturing improved for the first time in two quarters. As for manufacturing, it appears that improvements in exports and production associated with the recovery of overseas economies had a positive effect. The overseas supply & demand conditions for products DI of large enterprises in manufacturing was at +3%pt, an improvement in comparison to the previous survey when it was at 0%pt. This component has improved for seven consecutive quarters reflecting the recovery trend in overseas economies. The last time large enterprises in manufacturing managed to pull out of the negative numbers in this DI was on the June Tankan survey in the year 2008, a total of 38 quarters ago.

Meanwhile, the change in output prices DI rose by a modest amount for large enterprises in both the manufacturing and non-manufacturing industries. As for the non-manufacturing industry, upward pressure on costs has been generated in association with tightening of supply & demand conditions for labor, and movement toward price pass-through appears to be limited overall, leaving some questions. This seems to be consistent with the CPI statistics according to which the prevailing price for general services is depressed. Meanwhile, the high price of crude oil since summer and rising personnel costs have brought on an increase in change in input prices DI over change in output prices DI, and as a result, terms of trade (change in output prices DI – change in input prices DI) have worsened for large enterprises in both the manufacturing and non-manufacturing industries. The worsening of terms of trade could have a negative effect on corporate earnings in the future, and hence we advise caution.

Current profits revised upwards for both manufacturing and non-manufacturing

Sales projections of large enterprises for FY2017 were revised upwards by +3.8% y/y (a revision rate of +1.0%), reflecting the effects of the rebound from the decline in earnings experienced during FY2016. The upward revision for sales growth was a plus.

Current profit projections were also revised upwards significantly at +9.5% (a revision rate of +8.1%). Most notable is the manufacturing industry registered an upward revision due to the increase in exports backed by the recovery in the overseas economy, as well as the weak yen. Non-manufacturing also won an upward revision due to improvements in domestic demand. The assumed exchange rate for the second half of FY2017 for large manufacturers is 109.66 yen to the dollar, marking time in comparison to the previous survey's 109.12 yen to the dollar. The current yen rate shows a weaker yen than the assumed rate. Hence the current profit projections (actual value) of export-driven manufacturers for the full FY2017 period are expected to be higher than on the December BOJ Tankan.

FY2017 research & development investment is expected to maintain underlying strength

The FY 2017 capex projection for all enterprises in all industries (incl. investment in properties, but not investment in software and research & development) is +6.3% y/y, exceeding market consensus (+5.5%). Looking at the performance of large enterprises by industry, we see that capex projections of manufacturers for FY2017 are up by +10.2%, while large enterprises in non-manufacturing are at +5.8%. This is more or less along the lines of past revisions. High level corporate earnings were a plus for capex projections, but stagnant factory operating rates became a drag on performance.

Meanwhile, research & development investment, which is being publically announced for the first time on the March Tankan survey, was revised upwards somewhat by +3.4% (revision rate of +0.5) for corporations of all sizes in all industries. As for revision tendencies in the future, it will be necessary to monitor closely, but continued underlying strength is promising.

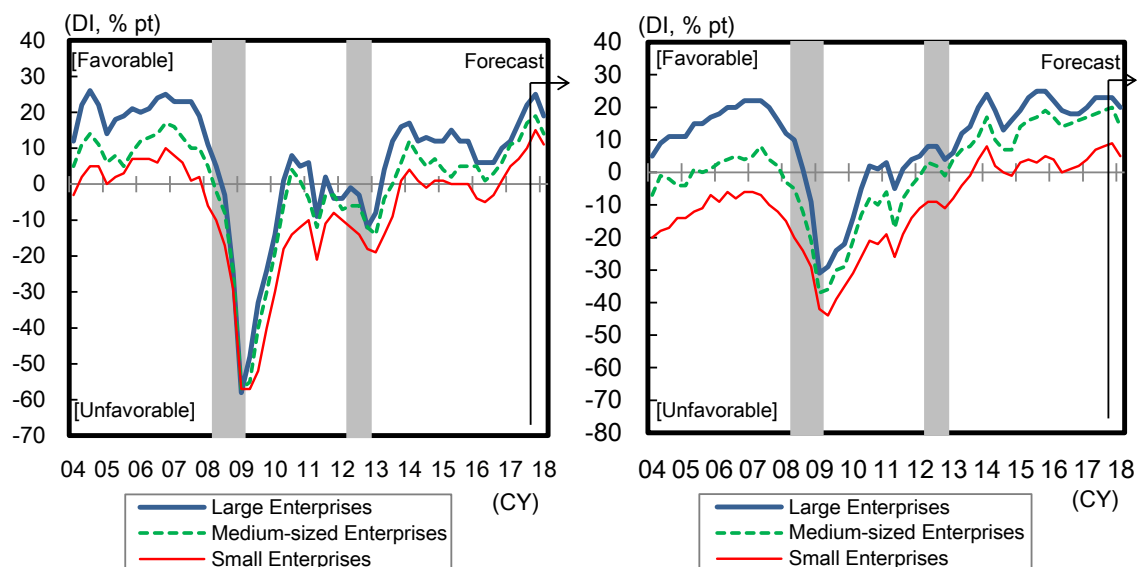
Looking at production capacity DI for large manufacturers, we see -2%pt, a decline in comparison to the previous survey's -1% (the sense of insufficiency is growing stronger), while large non-manufacturers marked time at -2%pt in comparison to the previous survey which was at -2%pt. As for the future, manufacturing was marking time, while non-manufacturing declined (the sense of insufficiency is growing stronger). Overall the sense of overcapacity for large enterprises is in a gradually declining trend.

Labor market to see further tightening

Employment conditions DI for corporations of all sizes in both manufacturing and non-manufacturing declined (supply/demand becoming tighter). The sense of a shortage of manpower is increasing amongst corporations. Employment conditions DI are expected to decline further in the future for both manufacturing and non-manufacturing centering on small and medium-size corporations, with the condition of the labor market expected to become increasingly tight. Although the tight labor market is a reflection of a good economy, the other side of this situation is that some industries are seen facing difficulties in acquiring the employees they need in the near future. Constraints in the supply of labor may become a drag on economic recovery in the future. Already we are seeing actual examples of industries where the shortage of manpower is being experienced especially intensely shortening hours and keeping controls on the pace of opening new branches. Companies will likely be required to improve conditions for their employees, either in the form of accepting more as regular employees or by increasing wages. Investment in acquiring personnel as well as investment in labor-saving systems will continue to be important. If corporations are unable to sufficiently carry out price pass-through

regarding their sales prices to cover the increase in personnel expenses, it could become a negative factor for corporate earnings, especially for small business and labor-intensive industries. The government announced its FY2018 tax reform outline on December 14. This document clarifies plans to shift from the current corporate tax system's approach using a tax system which promotes employment to a tax system which promotes income. The question of whether this successfully provides a push to improve the incomes of workers is something that will be monitored closely in the future.

Business Conditions DI (Left: Manufacturing, Right: Non-Manufacturing) Chart 1



Source: Bank of Japan, Cabinet Office; compiled by DIR.

Note: 1. Shaded areas denote economic down turns.

2. Due to changes in samples used in the forecast, there is some discontinuity between the December 2014 and March 2015 results.

	(DI, % pt)											
	Large Enterprises						Small Enterprises					
	Sep. 2017 Survey		Dec. 2017 Survey				Sep. 2016 Survey		Dec. 2017 Survey			
	Actual result	Forecast	Actual result	Changes	Forecast	Changes	Actual result	Forecast	Actual result	Changes	Forecast	Changes
Manufacturing	22	19	25	3	19	-6	10	8	15	5	11	-4
Textiles	6	3	6	0	0	-6	-22	-25	-20	2	-25	-5
Lumber & Wood products	29	18	24	-5	12	-12	-1	-1	-3	-2	-3	0
Pulp & Paper	10	3	10	0	-3	-13	-7	-8	-1	6	-12	-11
Chemicals	27	18	32	5	17	-15	18	10	21	3	12	-9
Petroleum & Coal products	31	19	38	7	25	-13	-5	-7	-4	1	-4	0
Ceramics, Stone & Clay	22	16	24	2	18	-6	6	11	7	1	13	6
Iron & Steel	12	14	18	6	14	-4	30	32	43	13	42	-1
Nonferrous metals	23	14	40	17	34	-6	30	27	37	7	33	-4
Food & Beverages	18	16	19	1	15	-4	11	9	9	-2	8	-1
Processed metals	8	5	13	5	3	-10	20	14	23	3	22	-1
General-purpose machinery	35	33	33	-2	37	4	23	13	33	10	16	-17
Production machinery	36	38	46	10	42	-4	22	13	27	5	20	-7
Business oriented machinery	30	30	23	-7	27	4	17	18	20	3	16	-4
Electrical machinery	27	26	27	0	25	-2	9	12	14	5	14	0
Shipbuilding & Heavy machinery, etc.	-14	0	-4	10	-4	0	14	11	16	2	10	-6
Motor vehicles	18	14	20	2	16	-4	30	22	32	2	22	-10
Basic materials	21	14	26	5	15	-11	8	5	12	4	9	-3
Processing	23	21	25	2	21	-4	14	11	17	3	12	-5
Nonmanufacturing	23	19	23	0	20	-3	8	4	9	1	5	-4
Construction	48	35	45	-3	38	-7	17	9	18	1	6	-12
Real estate	35	30	34	-1	28	-6	14	12	15	1	9	-6
Goods rental & Leasing	15	18	24	9	21	-3	20	16	24	4	20	-4
Wholesaling	21	15	24	3	16	-8	0	-2	3	3	0	-3
Retailing	8	13	10	2	15	5	-5	-4	-11	-6	-8	3
Transport & Postal activities	18	11	21	3	14	-7	8	4	9	1	5	-4
Communications	19	19	19	0	19	0	23	26	25	2	25	0
Information services	27	20	33	6	27	-6	17	12	18	1	18	0
Electric & Gas utilities	3	5	8	5	-3	-11	18	12	15	-3	18	3
Services for businesses	40	33	36	-4	32	-4	12	7	15	3	9	-6
Services for individuals	35	30	24	-11	27	3	7	3	6	-1	5	-1
Accommodations, Eating & Drinking services	6	7	0	-6	0	0	0	-2	-2	-2	1	3
All industries	23	19	25	2	19	-6	9	6	11	2	7	-4

Source: Bank of Japan.

Note: 1. DI = "Favorable" minus "Unfavorable"; % pt.

2. Shaded areas denote economic down turns.

3. Changes in forecast = "Forecast of the current survey" minus "Actual result of the current survey"

Sales and Current Profits Projections

Chart 2

Sales		(Year-to-year % change)			Current Profits		(Year-to-year % change)		
		FY2016	FY2017 (Forecast)	Revision rate			FY2016	FY2017 (Forecast)	Revision rate
Large Enterprises	Manufacturing	-2.9	3.9	1.2	Large Enterprises	Manufacturing	-0.5	15.0	9.8
	Domestic Sales	-1.5	3.8	0.8		Basic materials	8.1	16.9	9.1
	Exports	-6.1	4.2	1.9		Processing	-3.9	14.1	10.1
	Nonmanufacturing	-3.8	3.8	0.9		Nonmanufacturing	5.7	4.9	6.6
	All industries	-3.4	3.8	1.0		All industries	2.8	9.5	8.1
Medium-sized Enterprises	Manufacturing	0.1	4.4	0.9	Medium-sized Enterprises	Manufacturing	0.5	4.2	3.4
	Nonmanufacturing	0.9	2.5	0.1		Nonmanufacturing	9.2	-2.2	1.4
	All industries	0.7	3.0	0.3		All industries	6.4	-0.3	2.0
Small Enterprises	Manufacturing	-0.3	2.5	0.7	Small Enterprises	Manufacturing	16.4	0.7	3.8
	Nonmanufacturing	0.8	1.4	0.7		Nonmanufacturing	5.8	-6.0	2.9
	All industries	0.6	1.6	0.7		All industries	8.3	-4.3	3.2
All Enterprises	Manufacturing	-2.0	3.7	1.0	All Enterprises	Manufacturing	1.6	11.8	8.3
	Nonmanufacturing	-1.2	2.7	0.6		Nonmanufacturing	6.4	0.9	4.8
	All industries	-1.5	3.0	0.8		All industries	4.4	5.2	6.2

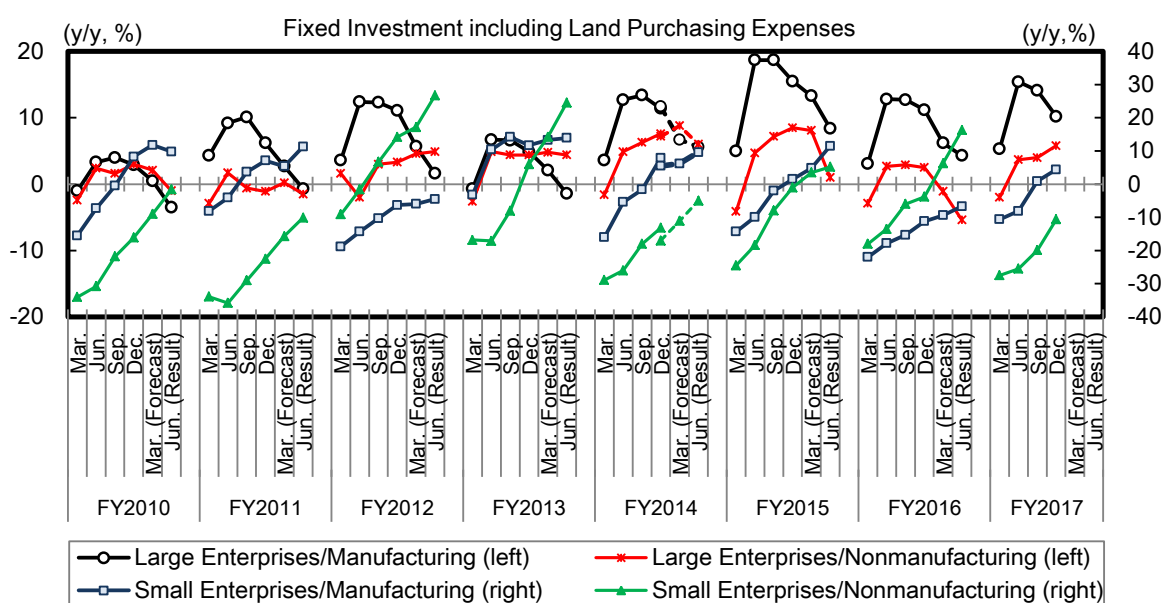
Note: Revision rates are calculated as the percentage change of the figures between the current and the previous survey.

Source: Bank of Japan.

Developments of Fixed Investment including Land Purchasing Expenses (excl. software investment)

Chart 3

Fixed Investment including Land Purchasing Expenses		(Year-to-year % change)			Software Investment		(Year-to-year % change)		
		FY2016	FY2017 (Forecast)	Revision rate			FY2016	FY2017 (Forecast)	Revision rate
Large Enterprises	Manufacturing	4.3	10.2	-3.4	Large Enterprises	Manufacturing	-5.3	5.4	0.8
	Nonmanufacturing	-5.4	5.8	1.8		Nonmanufacturing	8.8	6.9	1.2
	All industries	-2.1	7.4	-0.3		All industries	3.7	6.4	1.1
Medium-sized Enterprises	Manufacturing	6.3	15.3	1.8	Medium-sized Enterprises	Manufacturing	-5.4	27.5	-5.9
	Nonmanufacturing	-3.1	21.1	1.2		Nonmanufacturing	-9.5	10.0	0.4
	All industries	0.2	18.9	1.5		All industries	-8.9	12.6	-0.7
Small Enterprises	Manufacturing	-6.7	4.4	3.5	Small Enterprises	Manufacturing	-2.0	15.7	-5.8
	Nonmanufacturing	16.3	-10.6	11.5		Nonmanufacturing	11.3	19.5	-2.2
	All industries	8.8	-6.4	8.9		All industries	7.3	18.5	-3.2
All Enterprises	Manufacturing	2.6	10.1	-1.5	All Enterprises	Manufacturing	-5.1	7.6	-0.3
	Nonmanufacturing	-0.7	4.3	3.5		Nonmanufacturing	5.6	8.4	0.8
	All industries	0.4	6.3	1.6		All industries	2.1	8.1	0.5



Source: Bank of Japan.

Note: 1. Revision rates are calculated as the percentage change of the figures between the current and the previous survey.

2. The graph indicates the revision pattern of fixed investment. Namely, the first survey for each fiscal year (March survey) is on the left, and the last survey (June survey of the following year; actual result) is on the right.