21 September 2012 (No. of pages: 10)

Japanese report: 20 Sep 12

Japan’s Economy: Monthly Review

Examination of Japan’s Export Competitiveness

Japanese companies have to learn how to build brand equity from Germany and how to strengthen marketing power from South Korea

Economic Research Dept
Mitsumaru Kumagai

Summary

- **Economic outlook revised:** In light of the second preliminary Apr-Jun 2012 GDP report (Cabinet Office), we have revised our economic growth forecasts. We now forecast real GDP growth of +1.8% y/y for FY12 (previous forecast: +2.2%) and +1.2% for FY13 (+1.4%).

- **Main scenario and risks for Japan’s economy:** Despite the existence of downside risks, as our main scenario we believe that Japan’s economy will continue to expand gradually, supported by (1) reconstruction demand related to the Great East Japan Earthquake, (2) pickup of the US and Chinese economies, and (3) further monetary easing by BOJ. Risks facing Japan’s economy are (1) any deepening of the European sovereign debt crisis, (2) a surge in crude oil prices stemming from geopolitical risk, (3) further appreciation of the yen, and (4) the current account balance turning negative in the future.

- **Examination of Japan’s export competitiveness:** Examining Japan’s export competitiveness in comparison with Germany and South Korea, we found that the export competitiveness of Japanese companies has declined substantially centering on the electrical machinery industry. Japanese policy authorities should establish, in a balanced manner, three bulwarks against a strong yen: (1) BOJ should ease monetary policy further to brake the appreciation of the yen, (2) the economy’s ability to withstand a strong yen should be strengthened, and (3) policies should be actively implemented that take advantage of a strong yen. Also, Japanese companies will need to learn how to build brand equity from Germany and how to strengthen marketing power from South Korea.

IMPORTANT DISCLOSURES, INCLUDING ANY REQUIRED RESEARCH CERTIFICATIONS, ARE PROVIDED ON THE LAST TWO PAGES OF THIS REPORT.

Economic Research

1. Main Scenario and Risks for Japan's Economy

Economic outlook revised

In light of the second preliminary Apr-Jun 2012 GDP report (Cabinet Office), we have revised our economic growth forecasts. We now forecast real GDP growth of +1.8% y/y for FY12 (previous forecast: +2.2%) and +1.2% for FY13 (+1.4%). Expansion of Japan's economy has slowed slightly compared to our previous outlook, and risk of a downswing has increased.

Second preliminary estimate of Apr-Jun real GDP downgraded to annualized gain of 0.7% from first preliminary estimate

The second preliminary estimate of Apr-Jun real GDP posted a gain of 0.2% q/q, annualized at 0.7%, a downgrade from the first preliminary estimate (up 0.3%; up 1.4%), and falling short of the market consensus (up 0.3%; up 1.0%). In terms of contribution to q/q real GDP growth, the positive contribution of domestic demand narrowed (from +0.4% points in the first preliminary estimate to +0.2 points), while that of foreign demand was unchanged (at -0.1 point). Domestic demand contributed positively to such growth for a fifth consecutive quarter, but foreign demand contributed negatively for the first time in two quarters—the picture that domestic demand is driving overall growth of real GDP did not change from the first preliminary estimate.

Main scenario for Japan's economy

Despite the existence of downside risks, as our main scenario we believe that Japan's economy will continue to expand gradually, supported by three factors: (1) reconstruction demand related to the Great East Japan Earthquake, (2) pickup of foreign economies centering on the US and China, and (3) further monetary easing by BOJ. Regarding the direction of the world economy, which forms the premise of our current forecast, we assume that (1) eurozone economies will slow due to the sovereign debt crisis, (2) the US economy will trend firmly in broad terms, and (3) China's economy will gradually recover, supported by a political business cycle as a change in political leadership approaches.

Risks facing Japan's economy

Risks that will need to be borne in mind for Japan's economy are: (1) any deepening of the European sovereign debt crisis, (2) a surge in crude oil prices stemming from geopolitical risk, (3) further appreciation of the yen, and (4) the current account balance turning negative in the future. We currently believe the probability of Greece leaving the euro is around 30% to 40% and of the eurozone experiencing a full-fledged financial crisis around 10% to 20%.

2. Examination of Japan’s Export Competitiveness

2.1 Japan’s export competitiveness has declined

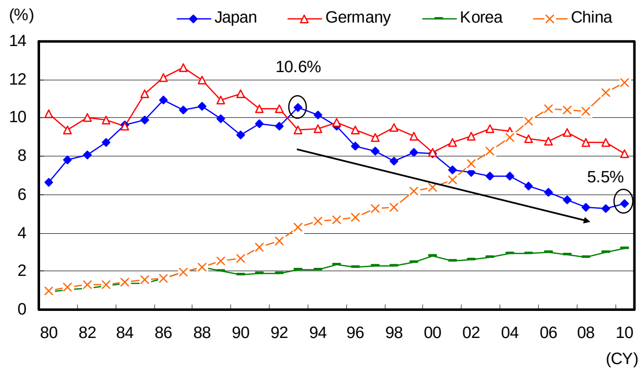
Japan’s export share continues to shrink

In this section, we examine the export competitiveness of Japanese companies in comparison with Germany and South Korea. Chart 1 depicts the trend of the export shares (national export value as a share of global export value) of major nations and we can see that in recent years Japan’s export share has trended steadily downward. However, in response to such factors as trade friction with the US, Japan has actively shifted production overseas since the 1990s and hence it would not be wise to measure the competitiveness of Japanese companies solely by export share. Nevertheless, even if we take this shift into account, there is no question that Japan’s export competitiveness is trending downward in broad terms.

Fall in Japan’s export share occurring simultaneously with worsening export profitability

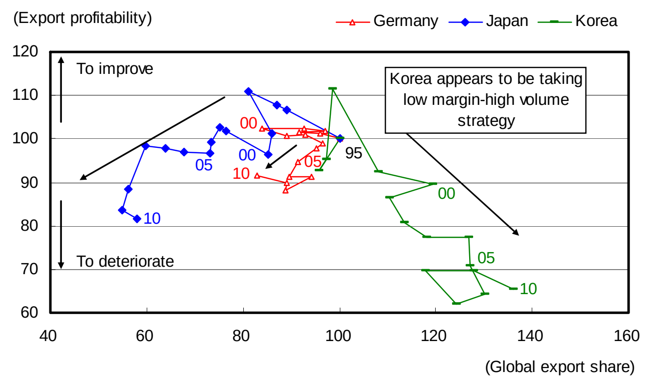
The point deserving emphasis is that Japan’s export share is shrinking at the same time that its export profitability is worsening. Chart 2 illustrates the export profitability and export share trends of Japan, South Korea, and Germany. The vertical axis shows the export profitability index (export prices [home currency basis] / corporate goods prices x 100) and the horizontal axis export share (nation’s share of global export value). In the graph, Japan is moving in the lower left direction, indicating that the decrease in export share is occurring simultaneously with a worsening of export profitability. This is precisely a situation of misfortune never coming alone. In contrast, South Korea’s export profitability is decreasing as its export share is rising, suggesting the possibility that it is pursuing some form of low-margin, high-volume strategy. In the case of Germany, it is maintaining export share at a certain level without seeing export profitability drop by much. This brings to mind the strong brand equity of Germany’s products led by its automobiles.

Global Export Share by Nation
Chart 1



Source: Research Institute of Economy, Trade, and Industry; compiled by DIR.
Note: Global export share=nation’s share of global export value.

Export Profitability & Global Export Share (1995 = 100)
Chart 2



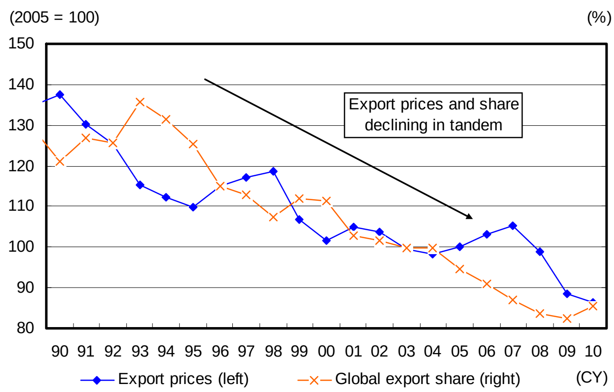
Source: Bank of Japan; Bank of Korea; Research Institute of Economy, Trade, and Industry; Statistisches Bundesamt; compiled by DIR.
Notes: 1) Export profitability = export prices (home currency basis) / corporate goods prices x 100.
2) Global export share=nation’s share of global export value.

Export prices and export shares of Japan, South Korea, and Germany

Next, in Chart 3, export price and export share trends are shown for Japan, South Korea, and Germany. As export prices decrease in Japan, its export share is falling, and the profit environment surrounding exports is worsening in both price and volume terms. From such a perspective, it is all too apparent that Japanese companies are placed in a difficult bind. In contrast, export prices are falling as export share increases for South Korea, giving a strong impression that the nation is pursuing a low-margin, high-volume strategy. In the case of Germany, backed by the strong brand equity of its products, export prices are steadily rising even as export share declines slightly.

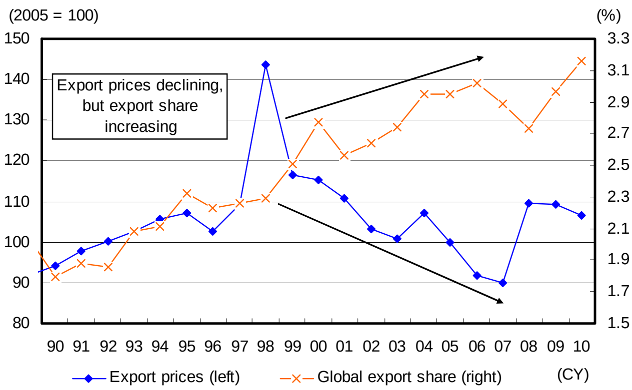
Export Prices and Global Export Share **Chart 3**

Japan



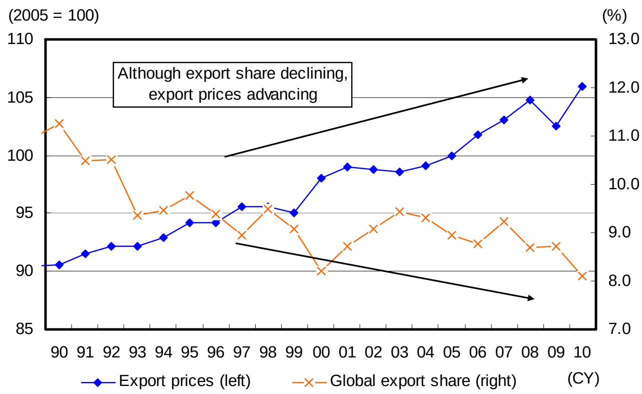
Source: Bank of Japan; Research Institute of Economy, Trade, and Industry; compiled by DIR.

Korea



Source: Bank of Korea; Research Institute of Economy, Trade, and Industry; compiled by DIR.

Germany



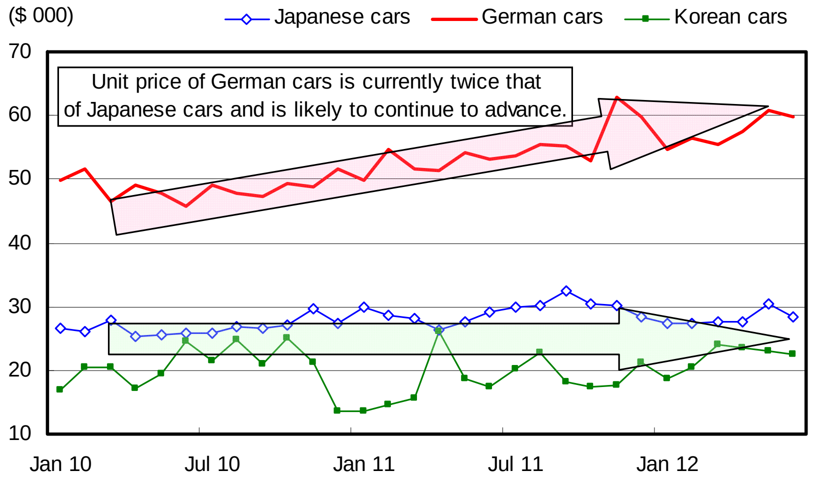
Source: Research Institute of Economy, Trade, and Industry; Statistisches Bundesamt; compiled by DIR.

Note: Global export share=nation's share of global export value.

Ascent of selling prices of automobiles in China offers a perfect example of Germany's strong brand equity

The ascent of automobile selling prices in China offers a perfect example of Germany's strong brand equity. Chart 4 portrays the unit price of China's imported vehicles. While such prices are generally trending flat for Japanese and South Korean vehicles, the trend being traced by German vehicles is completely different. The unit price of German vehicles is about twice that of Japanese vehicles, and such prices are continuing to trend upward, spotlighting Germany's strong brand equity.

Unit Price of Imported Cars in China **Chart 4**

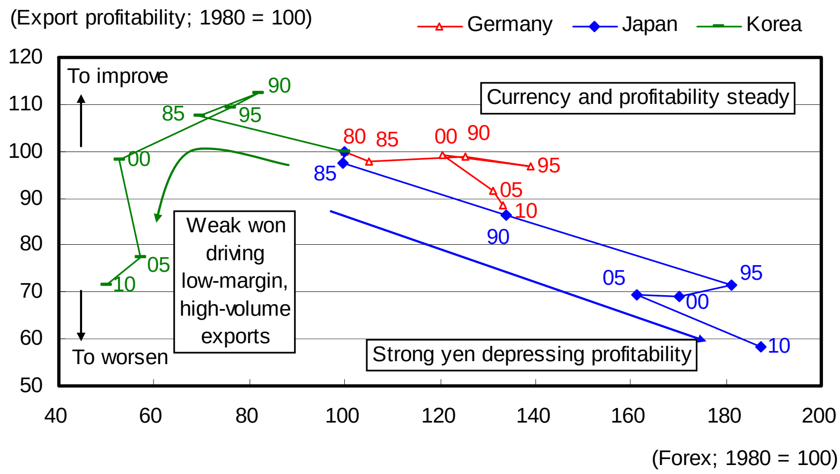


Source: China Customs; compiled by DIR.
Note: Unit price = import value / number of imported cars.

Strong yen squeezes export profitability of Japanese companies

Chart 5 illustrates export profitability and forex for Japan, South Korea, and Germany. The vertical axis shows the export profitability index (export prices [home currency] / corporate goods prices x 100) and the horizontal axis the foreign exchange index (export prices [contracted currency] / export prices [home currency] x 100). In the graph, Japan is moving in the lower right direction, verifying that the strong yen is squeezing the export profitability of Japanese companies. In contrast, South Korea has moved toward the lower left since the 1990s, suggesting the possibility that the nation is pursuing a low-margin, high-volume strategy aided by depreciation of the won. In the case of Germany, the nation has benefited from the introduction of the single currency (the euro in 1999, non-physical form), and its export profitability index and foreign exchange index are generally trending stably.

Export Profitability and Forex **Chart 5**

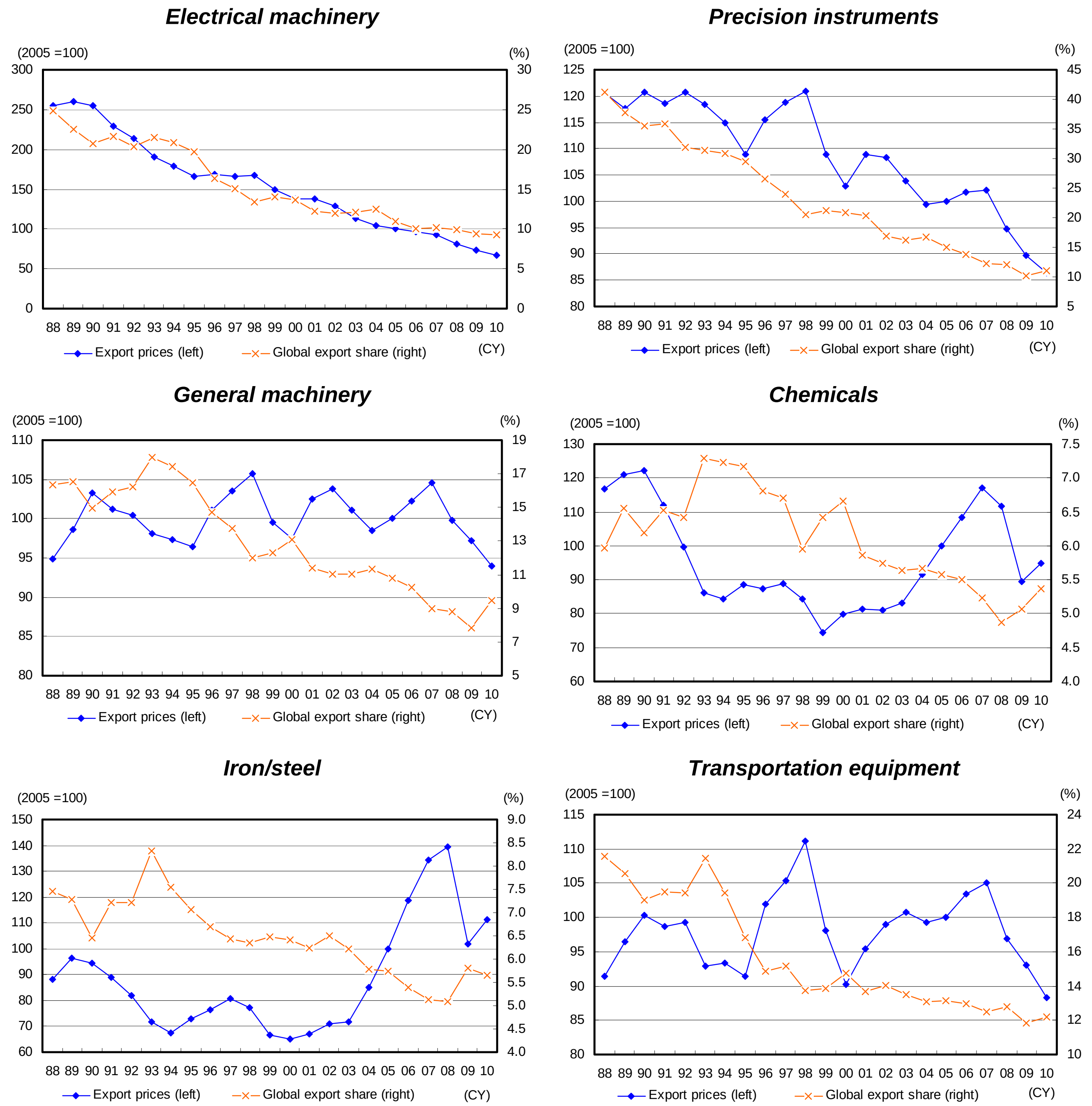


Source: Bank of Japan; Bank of Korea; Research Institute of Economy, Trade, and Industry; Statistisches Bundesamt; compiled by DIR.
Notes: 1) Export profitability = export prices (home currency) / corporate goods price x 100.
2) Forex for Japan and Korea = export prices (contract currency) / export prices (home currency) x 100.
3) Forex for Germany=nominal effective exchange rate.

Export prices and export shares by industry

Chart 6 depicts the export prices and export shares of Japan’s manufacturing industries. For the electrical machinery and precision instrument industries, export prices and export shares are falling simultaneously, and prices have eroded sharply for the former. In the case of the general machinery, chemical, and iron/steel industries, the decrease in export prices is contributing to higher export shares, and the decline in export prices is not altogether an adverse development. In the case of the transportation equipment industry, since this industry has shifted production overseas to a great extent, it is not all that meaningful to measure its competitiveness by export share alone.

Japan: Export Prices and Global Export Shares by Industry **Chart 6**



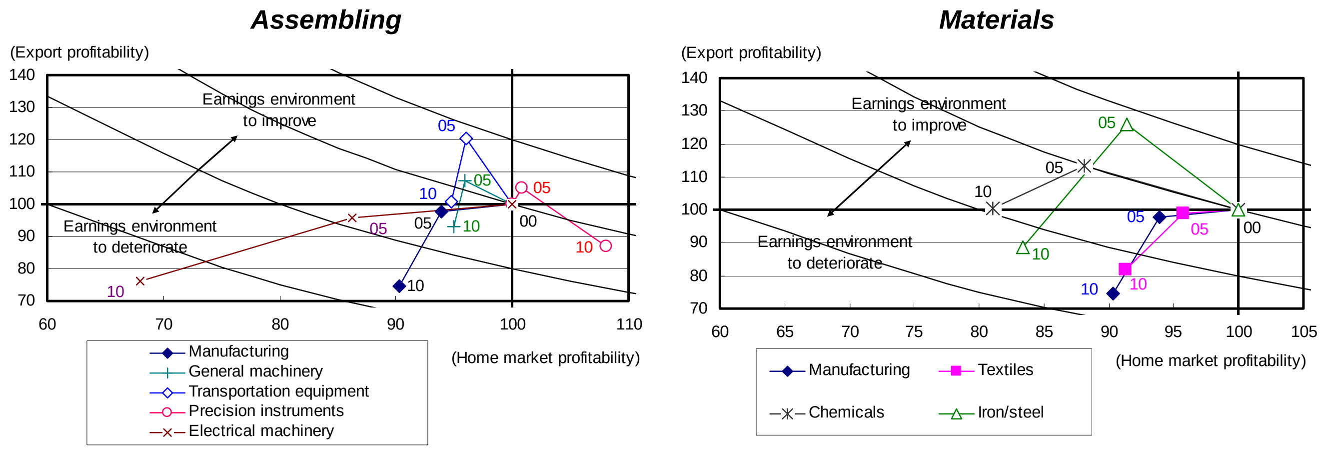
Source: Bank of Japan; Research Institute of Economy, Trade, and Industry; compiled by DIR.
Note: Global export share=Japan’s share of global export value.

Profit environment by industry: Profits are generally holding up for the assembly sector, but the situation is notably difficult for electrical machinery

In the previous paragraphs, we examined the situation surrounding the export sector. Chart 7 portrays the profit environment of Japan's manufacturing industries by considering the export sector and the domestic sector together. The vertical axis shows the export profitability index (export prices [yen] / output prices [home market goods] x 100) and the horizontal axis the home market profitability index (output prices [home market goods] / input prices x 100). The four parallel lines drawn from the upper left to the lower right indicate the combined profit environment surrounding companies. The nearer to the upper right the points are located, the further the profit environment has improved.

When we examine the profit environment for Japanese companies by industry, we find that profits are generally holding up for the assembly sector centering on the transportation equipment and precision instrument industries, although the situation is quite severe for the electrical machinery industry. In comparison, the materials sector appears to be experiencing a relatively more difficult profit environment than the assembly sector. However, as indicated in Chart 6, for the chemical and iron/steel industries, the decrease in export prices is contributing to higher export shares, and it is worth noting that the decline in export prices is not altogether an adverse development.

Manufacturing Industry: Export and Home Market Profitability (2000 = 100) **Chart 7**



Source: Bank of Japan; compiled by DIR.
Notes: 1) Export profitability = export prices (yen) / output prices (home market goods) x 100.
2) Home market profitability = output prices (home market goods) / input prices x 100.

2.2 Prescriptions for the recovery of Japan's export competitiveness

2.2.1 Responses required of policy authorities: Three bulwarks to counter appreciation of the yen

Three bulwarks to counter appreciation of the yen

We have remarked above that Japan's export competitiveness has declined, centering on the electrical machinery industry. In the paragraphs to follow, we examine the responses required of the policy authorities and Japanese companies under these circumstances.

In last month's issue, we presented an overview of the responses required of the policy authorities. In this issue, we focus on policy responses to the strong yen. As we have already noted, this is because a strong yen is placing enormous downward pressure on the export profitability of Japanese companies.

We believe that, for Japan's economy to counter the adverse effect of a strong yen, it will be important to establish, in a well-balanced manner, three bulwarks to counter the appreciation of the yen.

Bulwark 1: Braking the appreciation of the yen

The first bulwark is to brake the appreciation of the yen. To halt the yen's appreciation, it is insufficient for the Ministry of Finance to intervene in currency markets by selling yen. From the monetary side, BOJ should ease monetary policy further to support the Ministry of Finance. In logical terms, the appreciation of a currency can be prevented by the central bank printing money without limit. As underscored by a modified Soros chart presented last month, as a practical issue there is no reason to doubt that the policy stances of central banks have an enormous impact on currency markets.

Bulwark 2: Strengthen the economy's ability to withstand a strong yen

As a second bulwark, it will be necessary to strengthen the economy's ability to withstand a strong yen. What will be pivotal here is improving the foundations of Japan's economy through such policies as practical growth strategies, deregulation, reduction of the corporate tax, and participation in the Trans-Pacific Strategic Economic Partnership Agreement (TPP).

Participation in TPP will be of utmost importance. The conclusion of TPP is highly likely to have huge positive effects in the medium to long term for Japan's economy as a whole. If this is combined with efforts to strengthen the competitiveness of agriculture, offsetting the negative effects of TPP will be entirely possible.

History demonstrates that no nation has prospered by closing itself off from the world. If an open economy is achieved through TPP, this can be expected to stimulate innovation through the revitalization of trade and investment.

The government has estimated that Japan participating in TPP would have an economic effect of Y2.7 trillion over a 10-year period. This estimate, however, includes the effect of eliminating tariffs from participating in TPP, and the economic effect is understated.

TPP will have a far larger economic effect. The greatest benefit of participating in TPP is the expectation that innovation will be stimulated through the revitalization of trade and investment. If labor productivity can improve, centering on so-called “crouching dragon companies” (companies that are not living up to their full potential, so named by University of Tokyo Professor Yasuyuki Todo) whose business activities have been confined to Japan, participation in TPP in the final analysis has the potential of yielding economic benefits on a scale of Y100 trillion for Japan's economy.

Bulwark 3 Policies should be actively implemented that take advantage of a strong yen

Third, there will be a need to actively implement policies that take advantage of a strong yen. Since a strong yen means greater purchasing power for Japan, this advantage must be actively used. Specifically, it will be important to allot more funds for measures securing rare earth and for the promotion of strategic M&A. Moreover, to acquire resistance to forex fluctuations, an issue to consider is promoting the internationalization of the yen, a long-standing interest of Japan.

We believe that, rather than being swayed by the fluctuations of forex markets, resolutely strengthening these three bulwarks against the appreciation the yen will be an important key in improving the foundations of Japan's economy.

2.2.2 Responses required of Japanese companies: Strengthening brand equity and marketing power

Learning from German and South Korean companies will be important

There is much that Japanese companies can learn from their German and South Korean counterparts. Simply put, Japanese companies will need to learn how to build brand equity from German companies and how to strengthen marketing power from South Korean companies.

Response 1: Brand equity of German companies

What Japanese companies should learn from Germany is brand equity. The *White Paper on International Economy and Trade 2012* (Ministry of Economy, Trade, and Industry) notes in its analysis that large firms and small/medium-sized companies in Germany are committed to “made-in-Germany” quality and that there are many that have succeeded in developing and marketing products with high unit prices. The white paper also states that, by securing an admired position through determined branding, German companies can avoid price competition considerably and have succeeded in capturing demand from emerging economies. Japanese companies have sought to compete in price even as the yen appreciated. As a result, profitability shrank through lower export prices, and export share shrank at the same time. Given this situation, it is possible to say that Japanese companies have followed a strategy opposite to that taken by German companies.

The Chinese market will be the major battlefield in the future, and it has exhibited the strongest preference for brand than any other market. Hence, strengthening the brand equity of Japanese products through public- and private-sector initiatives will be an extremely important matter. With the view of supporting an improvement in Japanese companies’ brand equity from the side, it will be imperative for the Japanese government to provide subsidies of a certain level to facilitate cross-industry collaboration and to work to protect intellectual property.

Response 2: Marketing power of South Korean companies

The strength of South Korean companies is their marketing power. Manufacturing departments have traditionally had a strong say in Japanese companies, and marketing was consequently sidelined to a certain extent. Since the president/senior management come from manufacturing departments, the inordinate influence these departments have acquired should not be surprising. There is no question that Japanese companies, led by their manufacturing departments, produce high-quality products. However, the excessive emphasis on manufacturing has created a tendency to develop over-engineered products. In contrast, South Korean companies, based on careful marketing, manufacture high quality products within the scope of sellable prices. Thus, once price is factored in, Japanese companies can no longer compete with their South Korean rivals. In other words, Japanese companies win with technology but lose in sales. Going forward, Japanese companies will need to polish their marketing power even more than before.

To use a baseball pitcher as an analogy, technological power can be likened to the ability to throw fastballs. Japanese companies can throw fast pitches at 150 kilometers per hour. While South Korean companies can only throw fastballs between 130 and 140 kilometers per hour, they still outdo Japanese companies with their fine pitching control (marketing power). The strategy Japanese companies should adopt in a well-balanced manner going forward is to further polish their fastballs (polish leading-edge technological power and brand equity) and improve their pitching control (increased marketing power).

Outlook for Japanese Economy, Interest Rates

Chart 8

Indicator	2011 Oct-Dec	2012 Jan-Mar	2012 Apr-Jun	2012 Jul-Sep	2012 Oct-Dec	2013 Jan-Mar	FY10	FY11	FY12	FY13
	Actual			DIR estimates			Actual		DIR estimates	
Real GDP										
Q/q %, annualized	0.3	5.3	0.7	0.5	0.5	1.2				
Y/y %	-0.7	2.9	3.2	1.6	1.7	0.7	3.3	-0.0	1.8	1.2
Current account balance SAAR (Y tril)	6.7	5.9	5.4	5.6	6.1	6.2	16.7	7.6	5.8	6.9
Unemployment rate (%)	4.5	4.5	4.4	4.4	4.3	4.2	5.0	4.5	4.3	4.1
CPI (excl. fresh foods; 2010 prices; y/y %)	-0.2	0.1	-0.0	-0.1	0.1	0.1	-0.9	-0.0	0.0	0.1
Unsecured overnight call rate (period end; %)	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100
10-year JGB yield (period average; %)	1.00	0.98	0.89	0.80	0.85	0.90	1.15	0.99	0.86	1.00

Source: Compiled by DIR.
Note: Estimates taken from DIR's *Japan's Economic Outlook No. 174 (Update)*.