The Recovery in Manufacturing

By Katsuyoshi Shiina

Change is in the air. For the last few years, the Japanese manufacturing sector has been plagued by a resource glut and a reluctance to invest in real goods—both brought about by the combination of lower oil prices, lower interest rates and a stronger yen. Yet the word for 1987 is stability and growth.

On the microeconomic front, there is a growing feeling that the economy is bottoming out. Much of the credit for this goes to the expectation of a profit recovery in manufacturing after the long earnings slide that began in 1984.

Even in the United States, corporate earnings are clearly rebounding under the impact of exchange corrections and a manufacturing recovery. Although Japanese industry is still hurting from the way automobile export volume slumped when the yen went to ¥140–¥150/$, the terms of trade are improving, inventory adjustments are proceeding apace and fixed costs are being cut. The downward trend for export profitability is over.

A poor showing in fiscal 1986

Looking back at corporate performance in fiscal 1986 (April 1986 to March 1987), Japanese companies suffered the first declines in both earnings and profits in 28 years as a result of the appreciation-induced deflation. The aggregate for the 389 nonfinancial companies listed on the First Section of the Tokyo Stock Exchange that closed their business year in March (296 of them manufacturing and the other 93 nonmanufacturing firms) showed their earnings off 12.0% and their ordinary profits off 8.9% from the previous year.

The primary causes of this lackluster performance were the market gluts and the havoc the yen's average 28% appreciation played with prices. With cheaper oil, lower interest rates and yen appreciation, prices fell faster than costs could be cut, and export industries led the way in the plunge toward profit deterioration.

Operating profits, indicative of a company's performance in its main business lines, were down 15.5% overall. In manufacturing, the decline was 38.6%, and nonmanufacturing operating profits were actually up 1.9%. The number of companies running in the red rose to 51 (an increase of 23), roughly one in every eight companies.

With this deterioration in their main lines, companies moved to take advantage of the easier money and bull securities market to make their financial departments important profit centers. Formerly staid manufacturers metamorphosed into financial wheeler-dealers. As a result, their financial earnings were 14.6% improved overall (24.2% for manufacturing and 10.6% for nonmanufacturing), and the number of companies earning a profit in their financial accounts jumped by 18 to a total of 124 (close to one in three).

Export earnings were sharply off for basic material producers and assembly companies as a result of the yen's appreciating even as fixed costs rose. These companies' ordinary profits were down 29.4%. Yet those manufacturing companies that focused on domestic demand, such as petroleum, chemicals, pharmaceuticals and paper and pulp firms, saw their profits fatten as appreciation reduced their material costs.

In nonmanufacturing, electric power companies basked in the sunshine of low interest, cheap oil and a strong yen, and real estate and construction companies also scored record profits, to bring the sector's average ordinary profits up 15.2%.

Another characteristic of fiscal 1986 was that many companies sold off large amounts of securities to boost their nonoperating profits and moved considerable latent profits on-book. The leading 25 companies alone recorded securities trading profits of ¥700 billion—150% more than the previous year—¥510 billion for the 13 leading manufacturing firms (steel and transport machinery) and ¥190 billion for the 12 leading nonmanufacturing companies (trading companies and maritime transport).

Even so, the steel, shipbuilding and maritime transport industries went into the red, bringing the number of deficit-running industries to 16 (out of 29 total) and the number of deficit-running companies to 209 (out of 389 total). Whether by number of industries or by number of companies, over half were in the red. With the sharp erosion in corporate profits, 40 of the companies surveyed (over 10% of the sample) reduced their dividends and 14 decided not to declare any dividend at all. Companies are also cutting back on hiring and capital investment.

Outlook bright for fiscal 1987

In forecasting fiscal 1987 corporate results, it is important to note that oil prices, moving back up after bottoming out at $12 per barrel (CIF on arrival in Japan) in the first half of 1986 and climbing back to $15 per barrel in the second half, are expected to average $18 per barrel throughout 1987.

Important though oil prices are, the yen's exchange rate is even more important. In fiscal 1985, the yen averaged ¥221/$. In fiscal 1986, this sharply appreciated to ¥160/$. The expectation for fiscal 1987 is that it will settle down around ¥140/$. If the exchange rate stabilizes, management will be able to set cost-cutting targets more confidently and will be less uncertain of the future.

If the exchange rate stabilizes and prices remain stable, it is expected that manufacturers will be able to offset the yen's appreciation and stage a recovery. Except for the tumultous electric power and petroleum industries, industry is expected to increase earnings 1.9% and ordinary profits 12.5%, the strongest upturn in three years.

There are a number of reasons for this bullish outlook, foremost among them (1) progressive adaptation to the new exchange rates as manufacturers cut costs and get out from between the pinchers of high material costs and low product prices, (2) improved production positions as inventories are wound down and domestic demand remains firm and (3) the cash infusion from financial trading.

However, because electric power profits will be down sharply in the wake of rate cuts intended to pass along the benefits of the yen's appreciation, the totals for

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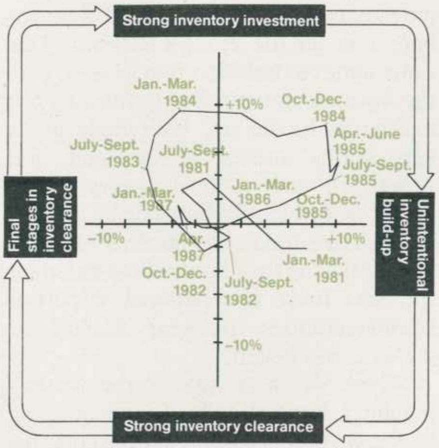
all industries will show earnings up 1.6% but ordinary profits down 4.0%—the third consecutive year of declining profits and the first time profits have slipped for three consecutive years since these industrial outlooks were first compiled in 1950.

Manufacturing is looking forward to a strong upturn after two poor years, with ordinary profits up 19.6% as a result of restructuring and price improvements. Meanwhile, nonmanufacturing faces the first profit decline in five years with an expected fall of 21.0%. As a result, the outlook is bright for manufacturing and grim for nonmanufacturing—a complete reversal of the situation that has prevailed for the last two years.

Fig. 1 Nearing the End of Inventory Adjustment



Note: The horizontal axis represents inventories and the vertical axis shipments, both compared to the previous year.

Among the main factors buoying the manufacturing outlook are (1) earnings improvement in semiconductors and stronger demand for computers for information networking systems and other uses, (2) a strong showing by chemicals as a result of price improvements and volume growth and (3) reduced deficits in shipbuilding as that industry slims down.

The assembly companies are also looking forward to 9.2% better profits with the recovery in electrical equipment. Raw materials businesses expect 19.5% higher profits as all but paper and pulp recover or continue to grow.

While electric power companies' profits will be down, the rest of the nonmanufacturing sector will show profits up 0.9% as maritime transport has cut costs and railway operations, trucking, construction, housing and real estate continue to grow.

As a result, with deficits being trimmed in shipbuilding and maritime transport and with steel going into the black, a total of 19 industries (13 manufacturing and 6 nonmanufacturing) will show increased profits, as will 269 companies (209 manufacturing and 60 nonmanufacturing). With two-thirds of all industries and 70% of all companies showing increased profits, the outlook for fiscal 1987 is for greater activity and more optimism about the microeconomy.

However, profits are not expected to recover fully until fiscal 1988. Ordinary profits for all industries are forecast at ¥3.7 trillion, which is only 80% of the record set in 1984. Excluding electricity and petroleum, the profit total is only 69% of the peak figure (up from 61% in fiscal 1986).

Providing the funds to lubricate industrial development, financial institutions have been very profitable. In 1986, for example, the 22 leading banks (commercial banks, trust banks and long-term credit banks) enjoyed ordinary profits of ¥2,465.4 billion—well in excess of the manufacturing sector's ordinary profits of ¥1,623.3 billion. These strong profits were because (1) as interest rates went down, the banks were able to take advantage of interest rate deregulation to lower their capital procurement costs before rates of return went down, thus giving them a better spread, (2) capital volumes were up and (3) banks showed sharply higher profits from bond and foreign exchange dealing operations.

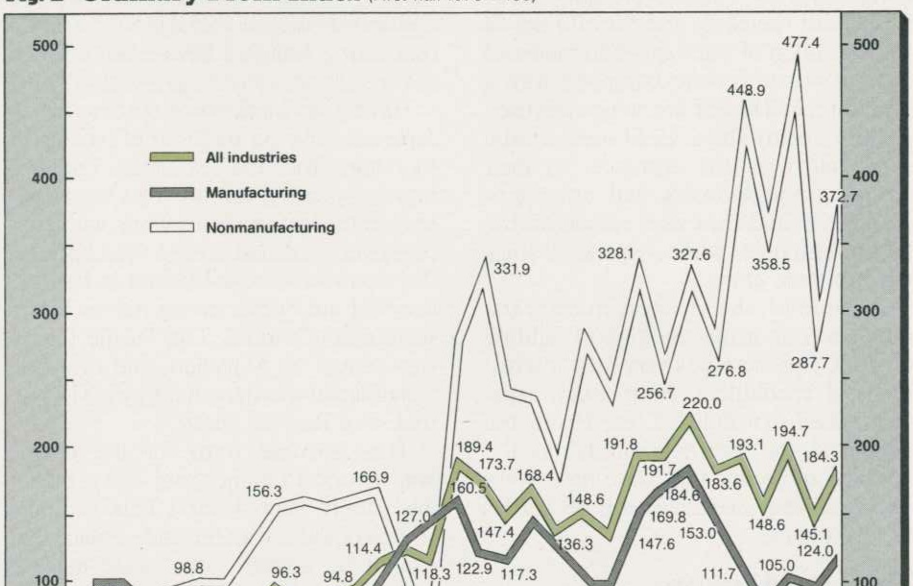
Thus, total ordinary profits for all industries (411 companies), including financial institutions, were up 7.2% in fiscal 1986 and are expected to be up another 0.9% in fiscal 1987.

Among the manufacturing industries that may be expected to revise their forecasts upward are chemicals and other market industries. With Japan, the United States and Europe having cut ethylene production capacity about 5 million tons over the last five years, the international market for ethylene is up sharply in the face of strong construction demand, firm consumer-related demand and stronger oil prices. Even prices for semiconductors, which are now subject to controls, have firmed up with the recovery in demand.

While banks and other nonmanufacturing companies benefited last year from the fact that their costs were low and their prices dear, it looks as though the manufacturing industries will be able to enjoy this combination this year as prices are firming, inventories are down and international market prices are moving up.

The economy is likely to become even more robust in the July–September quarter as the impact of expanded public works and other supplementary budget investment is felt, and there are a number of industries that are expected to revise their projections upward as they reap the benefits of expanded production. ●

Fig. 2 Ordinary Profit Index (First-half 1973 = 100)



Note: Figures for first-half 1987 are estimates and those for second-half 1987 forecasts.