

Recent Trends in Domestic Capital Investment

29 March 2024

- ▶ We have confirmed that progress in terms of quantity has been slow in recent domestic capital investment. This is attributed to disparities between nominal and real values, arising from rising raw material and labor costs. Additionally, the accumulation of order backlogs due to shortages of materials and manpower has contributed to this situation.
- ▶ Considering the persistent strong corporate appetite for investment, we anticipate that this gradual pace of progress will lead to a sustained expansion in capital investment at a macro level. In addition, the shortages in manpower and production capacity will drive further investment in automation and efficiency.
- ▶ It is worth noting that capital investment for automation purposes will support the potential growth rate amidst a declining population. Additionally, investments focused on improving efficiency are expected to result in increased labor productivity, thereby supporting sustained wage growth.

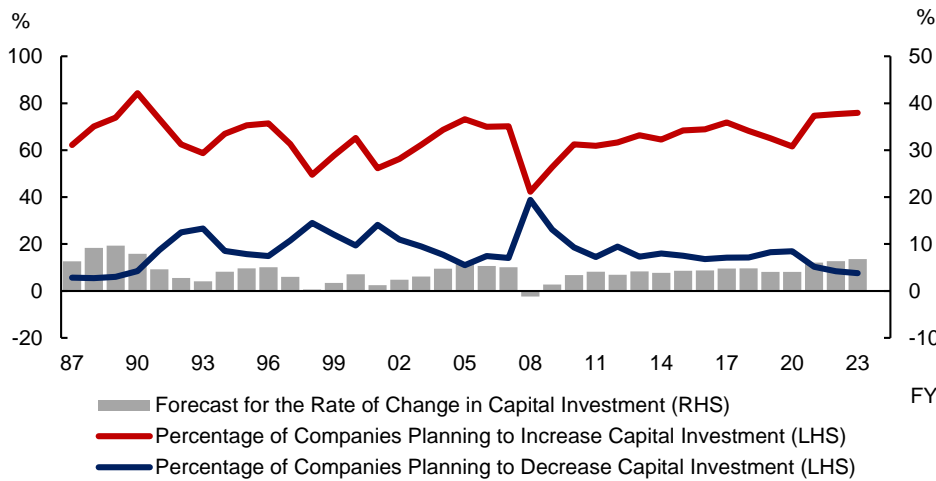
In Japan, there has been a notable shift in the economic phase from deflationary to inflationary conditions. This is evidenced by the increase in consumer price inflation rate, spring wage increase rate, and the Nikkei Stock Average, reaching levels not seen in approximately 30 years. Among these changes, one significant development is the strong willingness of corporations to invest in plant and equipment. According to the Cabinet Office's survey on corporate behavior conducted in January 2024, more than 70% of companies stated their intention to increase capital investment over the next three years, marking the third consecutive year for this trend. Conversely, the percentage of companies planning to decrease capital investment fell below 10% for the second consecutive year. The forecast for the rate of change in capital investment has also exceeded 6% year-on-year for the third consecutive year, a milestone not witnessed since the bubble period (Figure 1). Furthermore, during the October-December quarter of 2023, nominal capital investment reached a record-high level, surpassing 100 trillion yen, standing at 102.2 trillion yen (annualized, seasonally adjusted).



Yuko Iizuka, Economist

“Strong corporate appetite for capital investment”

Figure 1: Outlook for Capital Investment over the Next 3 Years



Source: Cabinet Office

Note: 1. Annual data from FY1987 to FY2023

2. The term “over the next 3 years” means, in FY2023, the outlook is for FY2024-2026, for example.

However, when examining the real value of capital investment, the growth remains limited to +1.9% year-on-year in 2022 and +2.1% year-on-year in 2023. This highlights the divergence between nominal and real values, which is measured by the capital investment deflator. It suggests that while corporate spending has increased, the progress in capital investment in terms of quantity has been comparatively modest.

“Divergence between nominal and real”

The strong appetite of companies for domestic capital investment can be attributed to two main factors: (1) the repatriation of production facilities to Japan and the attraction of foreign capital to strengthen the fragile supply chain exposed by geopolitical risks and the pandemic, and (2) automation and efficiency gains in response to labor shortages. A breakdown of fixed capital formation (including both private and public sectors) by form reveals these trends.

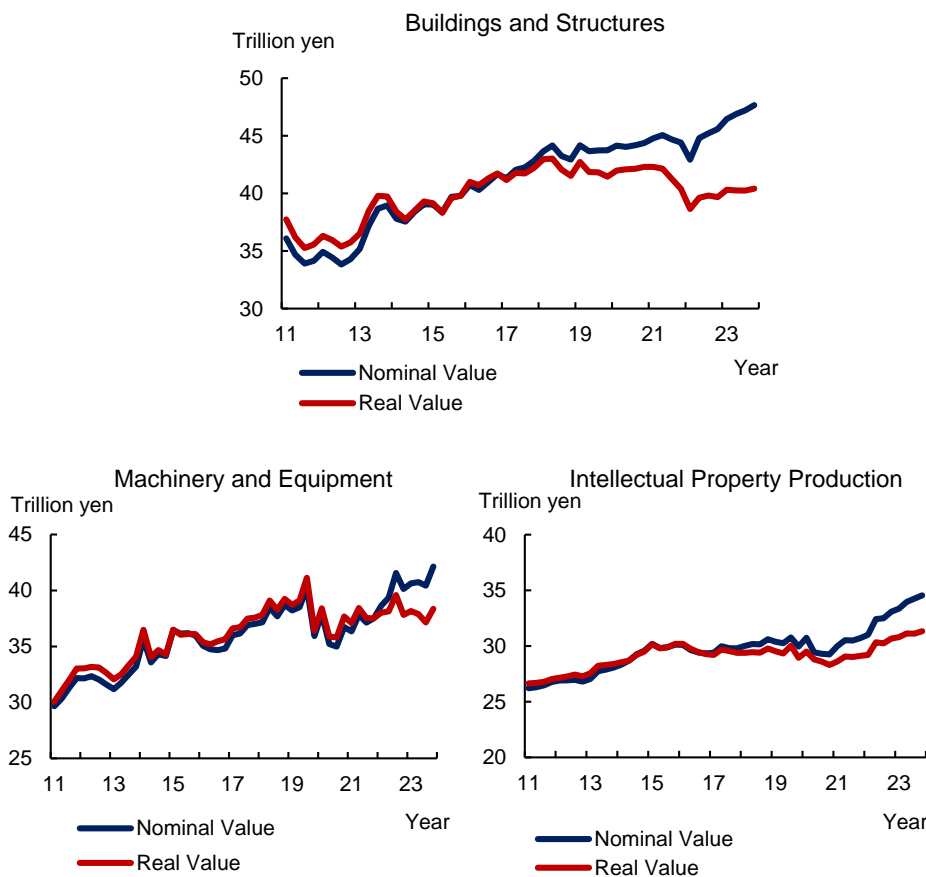
“Trends in capital investment by form”

For buildings and structures (such as factories, commercial buildings, infrastructure, and facilities), nominal values have been on an expansionary trend. However, real values have shown sluggish growth since the onset of the Covid-19 pandemic, and the gap between nominal and real values has been widening since 2022. This can be attributed to the impact of rising prices of construction materials and labor costs.

Both nominal and real values for machinery and equipment reached their peak just before the consumption tax rate was raised in October 2019. They then experienced a decline and reached their lowest point around the middle of 2020 before starting to recover. From 2022 onwards, both nominal and real values remained relatively stable but showed signs of improvement in the October-December period of 2023.

Regarding intellectual property production (including R&D, mineral exploration and evaluation, computer software and databases, original works of entertainment, literature, and art, etc.), it experienced a bottoming-out phase in both nominal and real values in the October-December 2020 period. Since then, it has been on an expansionary trend, despite the influence of the deflator. This indicates the strong appetite of companies for investment in software and other related products (Figure 2).

Figure 2: Breakdown of Fixed Capital Formation (excluding Housing)



Source: Cabinet Office

Note: 1. Quarterly data from Q1 2011 to Q4 2023

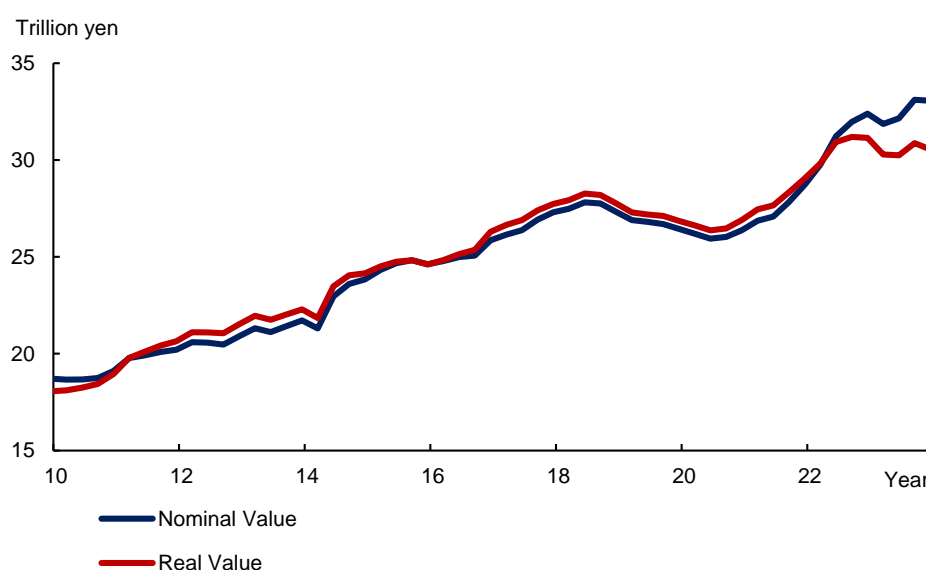
2. Annualized, seasonally adjusted

In addition to the surging costs of raw materials and labor, another factor contributing to the slowdown in capital investment progress is the delays in deliveries due to shortages of materials, labor, and other factors.

“Buildup of order backlog”

According to the Survey of Orders Received for Machinery, the backlog of orders has been increasing in real terms and has remained at a record-high level since 2022 (Figure 3). This is attributed to the disruptions in the supply chain caused by the pandemic, resulting in shortages of parts and materials. The domestic machinery industry has also faced challenges due to shortages of labor and production capacity. However, it is expected that the shortage of parts and materials will be resolved as economic activities resume in China and other countries. Additionally, production-related statistics indicate that the production capacity index for the semi-industrial, production, and industrial machinery industry reached its lowest point in September 2020 and has since increased by more than 6%. This suggests that the domestic machinery industry is actively expanding its production capacity to meet the growing demand.

Figure 3: Order Backlog for Machinery



Source: Cabinet Office

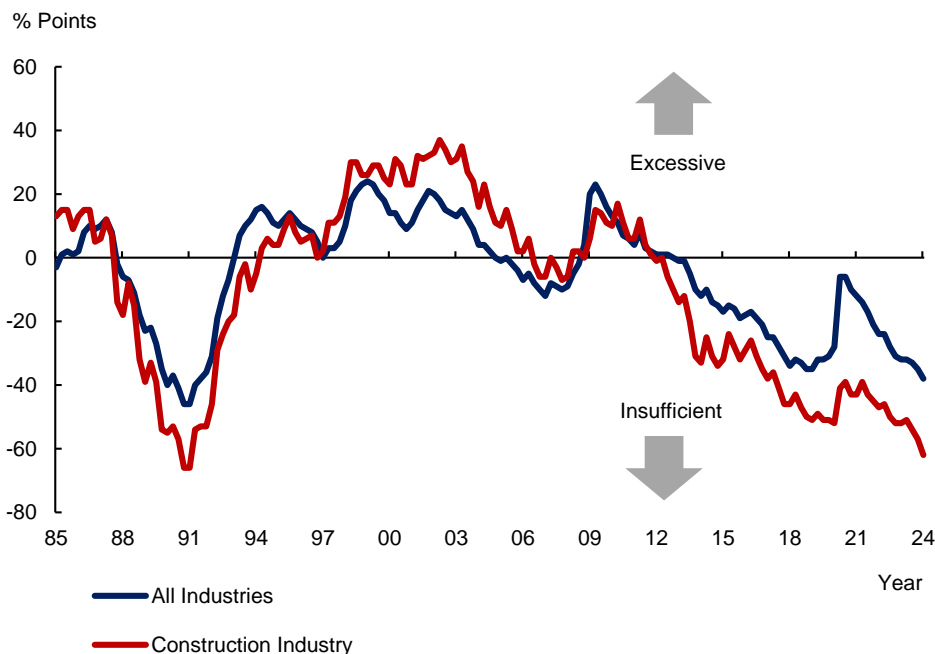
Note: 1. Quarterly data from Q2 2010 to Q4 2023

2. Excluding ships.

3. The deflator for other machinery and equipment in the form-based gross fixed capital formation is calculated as the quarterly average of a 4-quarter period and adjusted for inflation to obtain the real value.

To address concerns related to economic security, the government is attracting semiconductor-related factories through various means, including subsidy support. These factories are appearing in various regions, including Kyushu and Hokkaido. While labor shortages are observed in many industries domestically, the construction industry in particular is facing a significant shortage (Figure 4), with a job availability ratio (ratio of job openings to job seekers) exceeding 5, compared to the national average of around 1.2. Furthermore, from April 2024, regulations on long working hours will be extended to industries such as construction and logistics. This could further exacerbate the labor shortage, especially considering upcoming projects such as the construction of facilities for the Osaka Expo 2025 and the reconstruction projects following the Noto Peninsula earthquake.

Figure 4: Employment Conditions DI (BoJ Tankan)



Source: Bank of Japan

Note: 1. Quarterly data from Q1 1985 to Q4 2023

2. Employment Conditions DI = "excessive employment" - "insufficient employment", all size companies are included, and the most recent figures indicate forward-looking judgements.

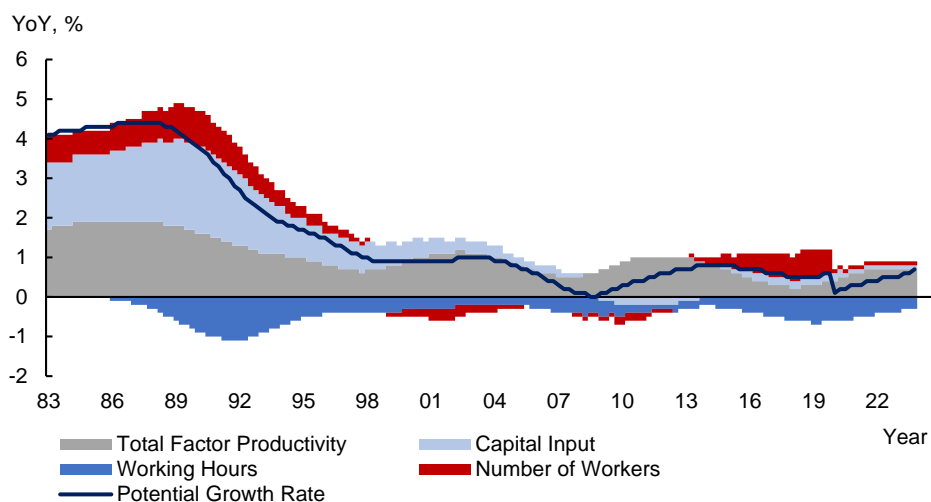
The gradual progress in capital investment is expected to provide a sustained boost to the economy, driven by the persistent strong corporate appetite for investment supported by robust corporate performance. Shortages in manpower and production capacity are also anticipated to stimulate further investments in automation and efficiency.

“Impact of capital investment on the domestic economy”

The potential growth rate showed signs of improvement, reaching 0.7% in the July-September period of 2023. However, considering the declining birthrate, aging population, and evolving work styles, labor-related growth, such as working hours and the number of workers, is not projected to increase significantly. The future trajectory of potential growth will depend on capital input and total factor productivity (Figure 5).

Following the pandemic, some companies have begun relocating their production bases to Japan, largely driven by the weakened value of the yen against the U.S. dollar. While labor and other cost burdens can be barriers to shifting factories from countries with relatively low labor costs to domestic locations, some companies have reported that advanced automation has enabled them to manage costs while maintaining domestic production. Capital investments aimed at automation and efficiency improvements are expected to support the potential growth rate, compensating for the effects of a declining population by increasing capital input and productivity. If efficiency investments lead to improvements in labor productivity, it is anticipated to sustain wage growth and contribute to a positive cycle of increasing wages and prices that has already begun.

Figure 5: Potential Growth Rate



Source: Cabinet Office

Note: Quarterly data from Q1 1983 to Q4 2023

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