Research and Statistics Department
November 10, 2005

The Improvement in Corporate earnings and Its Implications for the Japanese Economy*

---

* This is a translation of the Japanese original, which was released on September 20, 2005. The original paper was mostly prepared by the following staff of Economic Assessment and Projection. Analyses were mainly conducted by Sohei Kaihatsu (presently at Brown University), Yusuke Inomata and Masato Higashi. Supplementary analyses were conducted by Tomohiro Shigemoto, Tetsuma Arita (presently with the International Department), Yoshimitsu Shimizu (presently at the University of London), Tetsuya Yamada, Toru Hirasawa and Masayuki Sakata.

Charts were prepared by Naoko Igawa and Yuko Koyama. Kazuo Momma put together all the analyses.

ABSTRACT

1. Corporate earnings have been greatly increasing in Japan since FY 2002 as business conditions continue to recover. This ongoing improvement in corporate earnings has the following distinctive characteristics: (a) earnings have risen to a high level across a wide range of industries; (b) fixed expenses were greatly reduced and have subsequently remained suppressed overall; and (c) a gradual decline in prices has been coexisting with increases in both sales and earnings.
2. The following three points are believed to be important as the fundamental background to this increase in corporate earnings with these characteristics: (a) enterprises have seriously pursued full-scale restructuring following their experience of financial crises and with growing market discipline over management; (b) enterprises have benefited from a good global economic environment overall; and (c) there have been signs of a growing recovery in domestic demand as the “three excesses”, namely excess of debt, capacity and employment have receded.
3. Because overseas economies will decelerate somewhat and it will become difficult to suppress fixed expenses as much as to date, the predictions for FY 2005 are that it will become difficult to achieve the kind of large-scale profit growth seen through FY 2004. Regardless, corporate earnings which have already reached a high level are expected to support capital investment for the time being, and their positive effect on employee income is gradually becoming clear. The return of funds to shareholders via dividend payments and share repurchases has also begun to advance. Against the background of these developments, domestic demand is becoming increasingly firm, and a virtuous cycle whereby domestic demand then comes to support corporate earnings is becoming firmly established, albeit little by little.
4. Nevertheless, considering the scale of the problems facing the Japanese economy such as the declining fertility rate, aging of society and fiscal deficit, it would be desirable to make the earnings power and growth potential of

Japanese enterprises, which are the very sources of national income, even stronger. Whether or not Japanese enterprises can further enhance their value by agilely responding to developments in the global market, which offers many earnings opportunities but is severely competitive, has important implications for the future of the Japanese economy.

1. Characteristics of the Improvement in Corporate earnings in the Present Economic Recovery Phase

Amid the ongoing recovery in business conditions, Japanese enterprises have been recording unprecedented profits (Chart 1). According to Financial Statements Statistics of Corporations by Industry, current profits at Japanese enterprises rose for three consecutive years from FY 2002 and in FY 2004 surpassed the prior FY 1989 record high posted during the bubble economy.[1] Moreover, consolidated financial data[2] show that profits of listed enterprises continued increasing at an annual pace of more than 20% and their level in FY 2004 was about 50% higher than in FY 2000, the year of an IT boom. In fact, many Japanese enterprises posted record high profits in FY 2004.

The pace of profit increases is projected to ease during FY 2005 as the rate of growth in overseas economies slows somewhat and it becomes difficult to suppress fixed expenses as much as to date, while rising crude oil prices continue to put pressure on earnings. Nevertheless, projections of even small profit increases following the large increases through FY 2004 indicate continued good profit performance.

In terms of net income (Chart 2), the overall enterprise sector recorded a slight

---

[1] The profit ratio (ratio of current profit to sales) also posted a new record high of 3.15% in FY 2004, surpassing the previous peak of 2.98% recorded in FY 1989 (on a Financial Statements Statistics of Corporations by Industry basis, for enterprises of all scales in all industries).

[2] Continuous data are only available from FY 1999.

deficit for FY 2001, but has posted a large recovery since FY 2002 from the increase in current profits mentioned above combined with a general declining trend in extraordinary losses. This declining trend in extraordinary losses, which had previously ballooned, reflects that the emergence of asset sales losses accompanying restructuring and enterprise reorganization and the recognition of pension liabilities accompanying the introduction of retirement benefit accounting have already peaked. However, as a substantial number of enterprises posted impaired losses in FY 2004 prior to the mandatory adoption of asset-impairment accounting from FY 2005, the decline in extraordinary losses paused in FY 2004 and extraordinary losses remain high compared with the levels prevailing through the mid-1990s.

This concludes our outline of corporate earnings under the current economic recovery phase. The recent improvement in corporate earnings has the following distinctive characteristics: (a) profits have recovered across a wide range of industries, including materials and nonmanufacturing industries; (b) fixed expenses were sharply reduced during the initial stage of the economic recovery, greatly contributed to the profit recovery, and have subsequently remained suppressed overall; and (c) a gradual decline in prices has been coexisting with increases in both sales and profits. We now examine these three characteristics in that order.

(Wide-ranging profits improvement)

First, the improvement in corporate earnings has not been driven by a limited number of sectors, but is rather characterized by its spread across a wide range of industries. Comparing FY 2004 current profits with past performance by industry (Chart 3) reveals record-high profit levels surpassing those posted during the bubble era from the end of the 1980s through the beginning of the 1990s in a wide range of industries including transport machinery, general machinery and other processing industries; chemicals, steel and other materials industries, and nonmanufacturing industries such as real estate and wholesale and retail. Profits in the electrical machinery industry, however, were flat during the second half of FY 2004 as prices collapsed from intensified competition in the digital home electronics

market, and because of inventory adjustments in electronic parts and devices which were partially caused by the price collapse. For FY 2004 as a whole, profits in the electrical machinery industry did not reach the peak levels recorded during the IT boom in FY 2000. Yet even in the electrical machinery industry the profit levels are still as high as those during the previous peak prior to the IT boom. Overall, the present improvement in corporate earnings may be characterized as wide-ranging, covering both manufacturing and nonmanufacturing or both IT and non-IT industries.

The above profit figures are for large enterprises, and an examination of small and medium enterprises (Chart 4)[3] shows that their performance is somewhat behind that of the large firms. Specifically, while FY 2004 current profits were nearly 40% higher than those posted during the bubble era at large enterprises, they remain below the bubble era peak at small and medium enterprises, and the growth in current profits since current profits began rising this time has been less at smaller firms than at large enterprises.[4] Nevertheless, profits at small and medium enterprises have already clearly surpassed those recorded during the previous peak in FY 2000. So the improvement in profits overall is very broad, even when broken down by enterprise scale.

(Deep-rooted suppression of fixed expenses)

The second characteristic of the present improvement in corporate earnings is that fixed expenses were sharply reduced during the initial stage of the profit recovery, and have subsequently remained suppressed overall. Dividing the year-on-year

---

[3] In analyses using the Financial Statements Statistics of Corporations by Industry, large enterprises are defined as those with a capitalization of ¥1.0 billion or more and medium and small enterprises as those with a capitalization of less than ¥1.0 billion.

[4] One reason why the improvement in profits during the present economic recovery phase has been particularly pronounced at large enterprises may be that compared with small and medium enterprises, large enterprises have benefited more from the good global economic environment including the growth of the Chinese economy and the rise in materials prices, which are discussed later on.

current profit increase into fixed expense factors and sales factors (Chart 5)[5] shows that in FY 2002 when the present profit increase began the fixed expense factors, that is to say the reduction in fixed expenses, made an unprecedented contribution to increased profits. As the economic recovery subsequently continued and sales clearly increased, the rise in fixed expenses was minimal, showing that enterprises maintained a strong stance toward suppressing fixed expenses.

Mainly against this background, the break-even point declined in FY 2002, and its subsequent rise was limited (Chart 6).[6] In the years like FY 2003, especially FY 2004, when the increase in sales was clear, the administrative expenses and other items categorized as fixed expenses would normally tend to rise. But in fact the increase in fixed expenses and in turn the rise in the break-even point were suppressed to minimal amounts, and thus the sales increase directly led to an increase in profits. Consequently, the break-even point / sales ratio, which was holding at a high level through FY 2001, sharply declined over the next three years to around the lowest levels recorded during the bubble era.

(Large increase in profits along with a gradual decline in prices)

The third characteristic of the present improvement in profits is that corporate

---

[5] In Chart 5 a positive movement in "Fixed Expense Factors" indicates a reduction in fixed expenses, and a positive movement in "Sales Factors" indicates an increase in "sales – variable expenses." While it is difficult to precisely divide fixed expenses and variable expenses, in this paper fixed expenses are defined as personnel expenses, depreciation and amortization expenses, general and administrative expenses, and net non-operating expenses, while all other expenses (materials expenses, etc.) are defined as variable expenses.

[6] The break-even point indicates the sales level above which sales result in the generation of profits. So theoretically if the break-even point is decreased, profits can grow without any increase in sales, and in fact the FY 2002 profit increase under the decreased revenue was a manifestation of this phenomenon. Since the break-even point = fixed expenses / marginal profit ratio (where the marginal profit ratio = 1 – variable expenses / sales), the break-even point can only be lowered by reducing fixed expenses or increasing the marginal profit ratio.

earnings rose greatly to post new highs even as consumer prices and the GDP deflator continued to decline, albeit at a gradually easing pace (Chart 7).[7] Some caution must be paid to the fact that the corporate earnings examined so far do not include very small enterprises or sole proprietorships. In fact, the "operating surplus and mixed income" figures in the GDP statistics,[8] which are the broadest measure of corporate earnings, show a slower pace of increase compared with the earnings data we have seen so far: those by Financial Statements Statistics of Corporations and those of listed enterprises on consolidated basis (Chart 8 bar graph).[9] Nevertheless, the operating surplus and mixed income figures stopped declining in FY 2002 and rose by nearly 10 percent in FY 2003. So the fact that a price decline and an increase in corporate earnings occur simultaneously does not change even when using GDP statistics.

The first reason for this is the above-mentioned suppression of fixed expenses, especially of personnel expenses. In phases when prices are declining personnel expenses normally remain at a high level because of the downward rigidity of nominal wages, and consequently corporate profits are easily squeezed. In the current economic recovery phase, however, nominal wages and the number of

---

[7] While the rate of decline in consumer prices has recently approached zero, deceleration of decline in the GDP deflator has remained comparatively mild. This difference is to some extent because while higher crude oil prices are a factor which increases consumer prices, higher crude oil prices, through worsening in the terms of trade, are working as a factor that affects the GDP deflator negatively.

[8] "Mixed income" refers to the profits generated by the business activities of sole proprietorships. These figures are only released with the revised annual figures and not available at the initial estimates of quarterly GDP. The subsequent analyses only show the operating surplus, mixed income and unit profit (discussed below) through FY 2003 because the revised FY 2004 GDP figures were not yet released at the time of this writing (they are scheduled for release around December 2005).

[9] This is believed to be because fundamentally corporations with a certain scale of activities tend to be engaged in economic activities with large cyclical variations more than very small enterprises and sole proprietorships. In fact, the weight of corporate earnings in total "operating surplus and mixed income" tends to rise during economic recovery periods (Chart 8 line graph).

employees have both been strongly suppressed, so labor share – that is the percentage of nominal GDP distributed to households as employee compensation – has greatly declined, in contrast with its developments under the two prior recovery phases (Chart 9),[10] and this has had a positive effect on corporate earnings.

The second important reason is that the real value added generated in the economy as a whole has expanded and surpassed the influence from price declines, especially since FY 2003. In other words, nominal GDP turned to an increase.

To summarize these two points, dividing operating surplus and mixed income into (a) real GDP, (b) labor share and (c) GDP deflator factors (Chart 10) confirms that while the GDP deflator consistently worked to decrease corporate earnings, the large decline in labor share, especially in FY 2002 and FY 2003, and the clear increase in real GDP since FY 2003 have been factors working to increase corporate earnings.

The fact that personnel costs were suppressed while real value added increased can be restated as a large decline in unit labor costs. First, the suppression of the number of employees amid an increase in real GDP means that there was a rise in labor productivity. Meanwhile, the continued decline in nominal wages until very recently indicates a large decline in unit labor costs, which are the ratio of wage costs to labor productivity. In fact, the contributions of unit profit and unit labor costs to the fluctuations in the GDP Deflator (Chart 11)[11] shows that unit labor costs

---

[10] Enterprises made diverse efforts including the introduction of performance-based compensation and the greater use of non-permanent employees to realize this suppression of personnel expenses. For details regarding this point, see "The State of the Japanese Economy: From the Perspective of Employment and Income" (BOJ Research and Statistics Department) in the Winter 2005 edition of the *Bank of Japan Research Bulletin*.

[11] The GDP deflator (nominal GDP / real GDP) is simply the nominal income per unit of real value added generated in the entire economy, and the share of this distributed to enterprises is unit profit while the share distributed to employees is unit labor cost. Specifically, unit profit is calculated as operating surplus and mixed income divided by real GDP, and unit labor cost is calculated as employee compensation divided by real GDP.

declined for three consecutive years from FY 2002 and that those declines absorbed nearly all of the decreases in the GDP deflator. In other words, it can be said that the large decline in unit labor costs under the strong enterprise stance toward suppressing fixed costs is considered as an important aspect of the background to these developments whereby profits continued to increase while prices continued to gradually decline.

2. Background to the Improvement in Corporate earnings

In light of the characteristics presented above, the following three points are believed to be important as the fundamental background to the increase in corporate earnings: (a) enterprises seriously pursued full-scale restructuring, especially during the initial stages of the recovery; (b) enterprises have benefited from a good global economic environment overall; and (c) there have been signs of a growing recovery in domestic demand as the “three excesses”, namely excess of debt, capacity and employment have receded. These three points are now examined in order.

(1) Serious Pursuit of Full-scale Restructuring

Many Japanese enterprises implemented full-scale restructuring from the end of the 1990s through the beginning of the 2000s in an effort to regain their earnings power and improve their balance sheets. Industry reorganization and consolidation advanced as a response to excess capacity and debt, which are sometimes difficult to resolve within the framework of individual enterprises. Three important reasons why enterprises implemented full-scale restructuring at that time were: (a) reinforcing balance sheets came to be recognized as a vital issue following the financial crisis of 1997-1998; (b) capital market discipline over financial conditions

---

However, because nominal GDP includes not only employee compensation and operating surplus and mixed income but also depreciation and amortization, indirect taxes, other items, and statistical discrepancies, the sum of the contributions of unit profit and unit labor cost does not equal the GDP deflator.

and earnings power strengthened as international standards were adopted for accounting and other systems and the weight of foreign investors rose on Japanese markets; and (c) financial institutions accelerated their disposal of nonperforming loans, forcing enterprises with excess debt to advance restructuring and reorganization measures.

The financial crisis of 1997-1998 meant that the conventional system for enterprise revitalization, which assumed long-term stable funds provision by main banks, was no longer functioning sufficiently. For that reason, awareness of corporate bond default risk heightened on the capital markets, which came to view enterprise balance sheets and earnings power with greater scrutiny than before. In fact, estimating the factors behind corporate bond ratings confirms that profitability indices such as Return on Equity and debt repayment capacity indicators such as debt-equity ratio and the interest coverage ratio played an important role. (Charts 12(1) and 12(2)).[12] What draws attention here is that the parameters of time dummy variable declined greatly in FY 1998 (Chart 12(3)), which suggests that from around that time there may have been some downward pressure on ratings that cannot be explained solely by the worsening of balance sheets and earnings power.[13] Under these conditions, it seems enterprises were forced into a stronger orientation toward improving their balance sheets and earnings power to secure high evaluations from capital markets and thereby enhance the stability of their funds procurement.

---

[12] A detailed explication of this estimation can be found in "Will Japanese Companies Achieve a Full-Fledged Recovery? – Evaluating the financial improvement of the companies using the estimated equation for forecasting credit ratings –," BOJ Research and Statistics Department *Economic Commentary* (Sohei Kaihatsu, Feb. 2004).

[13] In other words, this result suggests that, at that time, bond ratings companies came to realize that rescues by main banks could no longer be expected to lower the default risk of corporate bonds issued by borrower companies. Looking at this same development from the enterprises' perspective, it implied that their desirable debt-to-equity ratios had declined because of decreased credibility in their main banks. These changes apparently prompted enterprises' subsequent moves to reduce their interest-bearing debt.

In addition to these changes in the funds procurement environment sparked by the financial crisis, a series of accounting system reforms known as the “accounting big bang” were advanced from around the year 2000, including the emphasis on consolidated financial statements, the adoption of market valuation for a broader range of assets, the wider adoption of quarterly profit disclosure, and the introduction of asset-impairment accounting. These changes in accounting rules and practices made enterprises’ earnings power and balance sheet positions more visible and transparent to the markets. Furthermore, the unwinding of cross-shareholdings advanced as financial institutions could no longer withstand the risk of holding large quantities of shares, and instead foreign investors expanded their presence. The present economic recovery began amid these structural changes in the relationship between capital markets and enterprises. Incidentally, the Cabinet Office conducted a questionnaire survey on the interests of managers in January 2002, right around the trough of the business cycle. The survey indicates that a shift in managers’ main objectives from increasing sales and profits in absolute terms to boosting capital efficiency and return on investment was clearly emerging at that time (Chart 13(1)). The survey also indicates that to realize such improvements in capital efficiency, managers were keenly advancing thorough evaluations of profitability in business plans and capital investments, strengthening inventory management, and other financial strategies to reduce assets that do not generate profits (Chart 13(2)).

In fact, the figures for Return on Assets (ROA), which is a representative index of asset efficiency calculated as the ratio of current profits over total assets (Chart 14), show that the increase in ROA during the present profit increase phase surpasses those during the three previous profit growth phases, including the bubble era. Certainly the increases in total assets were restrained also during the two previous profit growth phases, but it is important to note that this time total assets were restrained amid a large profit increase. This indicates a high likelihood that the selection and concentration of businesses has been more thorough during the current phase than in the past.

(2) Favorable Global Economic Environment

(Good performance in the IT, automobiles and materials industries)

The timing when the results of Japanese enterprises' full-scale restructuring efforts were gradually surfacing just happened to coincide with acceleration in global economic growth in 2003 and 2004 (Chart 15). From around 2000 Japan's automobile and other manufacturing industries were markedly strengthening their overseas bases, and the consolidated financial data by location indicate that the weight of overseas sales in total sales is rising (Chart 16(1)). Moreover, the profits realized by local overseas subsidiaries contribute to boosting the profits of their Japanese parent firms via dividend payments and payments for the use of industrial rights (Chart 16(2)). The global economic growth which accelerated during 2003 and 2004 has provided a perfect tailwind for Japanese enterprises which has been in the process of globalization as shown above.

(a) IT

The IT sector has its own particular cycle, and global IT-related demand expanded through the first half of 2004. Specifically, the demand for personal computers and cell phones expanded along with market growth in emerging economies and replacement demand for higher function models in the developed nations. What is more, the digital home electronics market for goods such as flat-screen TVs, DVD recorders and digital cameras was in a worldwide growth phase. This expansion of IT-related demand prompted a V-shaped profit recovery at Japanese IT-related enterprises which enjoy comparative advantages in digital home electronics goods, parts and materials and in high value-added electronics parts, and which had reduced their costs via restructuring.

From the second half of 2004, however, the supply capacity caught up with the growth in the digital home electronics market, leading to inventory adjustments and accompanying large price declines. Profits at IT-related enterprises topped out overall, while there were performance gaps among individual firms resulting from differences in their management strategies. Despite that, FY 2004 electrical

machinery current profits were not appreciably lower than those recorded during the IT boom in FY 2000 (Chart 3, above).

(b) Automobiles

While the domestic automobile market has already reached a mature stage, automobile firms improved their performance, especially those which skillfully grasped the demand on expanding overseas markets. The strengthening of the overseas strategies of the Japanese automobile industry is particularly pronounced in the above-mentioned fact that Japanese automakers have been appreciably increasing their overseas sales ratios over the past 2-3 years (Chart 16(1) above). This trend was helped by the favorable global economic environment which was exemplified by the steady expansion of the US economy, which is the world's largest market, and the growth in automobile demand in developing nations. Japanese automakers have also implemented thorough cost-cutting, products quality improvement and other measures to boost their competitiveness, and have thereby expanded their market shares, especially in the US. In this regard, the revival of one of the leading automakers which had once fallen into difficulties created more competitive environment among Japanese players, forcing not only automakers themselves but also parts and materials suppliers to enhance the efforts to strengthen their operations. It seems that this contributed to higher international competitiveness of Japanese automobiles. Moreover, the sharp rise in gasoline prices recently has further boosted the competitiveness of Japanese cars, which have advantages in terms of high fuel efficiency and products incorporating technologies that respond to environmental concerns.

(c) Materials

The sharp recovery of earnings power in the Japanese materials industry can first be attributed to the progress of consolidation in all areas of the industry over the past several years (Chart 17)[14], which led to the scrapping of obsolete and

[14] Industrial consolidation has also advanced throughout the global materials industry

excessive equipment and thereby the recovery of pricing power. These changes on the supply side were accompanied by the tailwind of an expansion in the global economy that was just beginning to become clear, especially economic growth in China and the other emerging economies.[15] In fact, the geographical breakdown of Japan's real exports (Chart 18) shows a remarkable expansion in exports to China from 2002 through the first half of 2004, after China entered the WTO at the end of 2001.[16] Japanese exports to the NIEs and ASEAN also steadily expanded. These increases may also be partially attributed to the increase in global IT-related demand and indirectly to the economic growth of China and other emerging economies.

This economic growth in the emerging economies which has been a distinctive characteristic of the global economy over the past 2-3 years, especially during 2004, has led to a tightening in the supply-demand balance for materials that had not been witnessed in more than two decades.[17] This significant increase in the demand for materials and the accompanying sharp rises in materials prices contributed to profit increases not only in materials manufacturing industries such as steel, oil and chemicals, but also at some nonmanufacturing industries such as marine transportation, which benefited from the tight supply-demand balance for shipping, and trading companies, which had large stakes in energy area (Chart 19). This extremely good profit environment for materials-related industries is one of the

---

following the long-lasting stagnation of materials market conditions up until several years ago. For example the market share of the top three global iron ore producers rose from about 23% in 2000 to 30% in 2003. There have also been a series of large-scale mergers over the past few years in the steel, non-ferrous metals, oil and other materials industries.

[15] Recently, rapidly growing emerging economies are often symbolized by four large population countries known as "BRICs" (Brazil, Russia, India and China).

[16] On a real exports basis, Japanese exports to China rose by 42% in 2003 and by 22% in 2004. On a nominal value basis, the exports rose by 33% in 2003 and by 20% in 2004. China's share of Japan's total exports on a nominal value basis rose from 8% in 2001 to 13% in 2004.

[17] The CRB Commodities Index, which is a widely watched international commodities index, rose to its highest level in about 24 years.

reasons for the achievement of high profits across a wide range of industries during the present economic recovery phase.

(Deepening international division of works)

Moreover, the above-mentioned economic growth in the emerging economies did not just result in an expansion of the global market but also contributed to an improved efficiency in the international allocation of resources through the activities by enterprises of industrialized nations, including Japanese enterprises. The sharp economic growth of the emerging economies in recent years, as typified by China after it became a member of the WTO, has largely been realized by combining the technologies and management know-how of enterprises from advanced countries with abundant supply of local labor resources. Direct foreign investment by Japanese enterprises in China expanded from around 2000 and accelerated substantially in 2003. This is one reason why Japan's trade with China has greatly increased, not only the above-mentioned exports from Japan to China but also the imports from China into Japan (Chart 20).

In its initial stage, this deepening of the international division of works possibly decreased the profit margin of Japanese firms via the intensification of the competitive environment. The China-is-a-threat sentiment prevailing among Japanese business leaders a few years ago was an expression of those conditions. However, as Japanese enterprises have responded, for example, by concentrating on high value-added goods and services in their domestic production activities, a positive effect has apparently emerged from the broader range of management choices including the optimal location of production processes and the diversification of procurement routes. In fact, examining Japan's trade relations with China and the rest of East Asia in the machinery sector, while the aggregate figures indicate imports and exports moving in both directions within the same industries, the details show that the trade is increasing in items that differ greatly in terms of their factor intensity and value-added ratios (Chart 21)[18]. This strongly suggests that

[18] For example, even within the same "electrical machinery" industry, factor intensity

the division of roles between Japan and the rest of East Asia is advancing. This has also created new profit opportunities in distribution-related nonmanufacturing industries such as transportation, wholesale and retail. It is difficult to quantify these merits since they are broadly spread out. Nevertheless, it is highly likely that the upgraded international division of works in recent years overall has exerted a positive influence on the profits of Japanese enterprises.

(Increased quantities that compensated for worsening terms of trade)

Given the global economic environment and its influence on the profits of Japanese enterprises as above, we now look at the breakdown of the profit increases from FY 2002 into quantity factors and price factors, although the analyses are limited to manufacturing sector where necessary data can be easily obtained (Chart 22).[19]

First, the results of the analyses show that in FY 2002, when the present profit increase began, the rise in current profits was mostly realized from reductions in personnel expenses and other fixed expenses. While fixed expenses then rose slightly in FY 2003, they fell once again in FY 2004, contributing to higher profits. Thus the analyses confirm that enterprises' stance toward restraining fixed expenses was strongly rooted, especially in the manufacturing sector.

---

substantially differs from item to item, ranging from highly capital-intensive goods to highly labor-intensive goods. Chart 21, based on the estimated factor intensity of each item, attempted to classify the trades according to the nature of division of works. It is clearly shown that the share of the "vertical" intra-industry trade, defined as the trade between the items belonging to the same industry but differing in factor intensity to each other, has been greatly expanding between Japan and the rest of East Asia. For details regarding this point, see the Bank of Japan *Working Paper Series* "Trade Patterns in Japan's Machinery Sector (in Japanese)" (Hitoshi Sasaki and Yuko Koga, July 2005).

[19] The analyses are further limited to large enterprises because many of the samples for the small and medium enterprise data are discontinuous and thus not suited to these kinds of analyses. Moreover, the analytical results need to be viewed broadly because even for large enterprises it is difficult to accurately divide fixed expenses from variable expenses, and because the input and output prices used for the analyses are based on a rough industry classification.

Second, the results show that the negative contribution from price factors increased from FY 2003.[20] That was because the rise in crude oil prices and the tight supply-demand balance for raw materials worsened the terms of trade for the manufacturing sector as a whole. In other words, the profitability per unit product worsened.

Third, however, the results show that quantitative factors made a large positive contribution from FY 2003, and that a large profit increase was realized overall because this positive contribution from quantitative factors greatly surpassed the above-mentioned negative contribution from price factors.

These results are consistent with the previous findings which showed that an increase in corporate earnings was realized amid a decline in the GDP deflator because worsening profitability per unit of real value added was more than offset by the decrease in labor share and the increase in real value added.

Next, dividing this factor analysis into the materials industry and the processing industry (Chart 23) reveals that the increase in the negative contribution from price factors from FY 2003 mostly came from the processing industry. In the materials industry, even in FY 2004 when crude oil and other commodity prices rose sharply, higher costs of inputs were thoroughly passed on to output prices amid the strong demand in Asia for their products, and thus price factors did not come to squeeze profits. For that reason, the large increase in quantitative factors was directly reflected in good business performance.[21]

---

[20] In these analyses "quantity" is not necessarily limited to the number of units or number of tons, and its flip side is that "price" is not limited to nominal unit price. For example, in cases when the number of units sold and the nominal prices remain unchanged but the functions or quality improve, the "quantity factors" defined here become positive and the "price factors" become negative.

[21] Most Japanese petroleum refineries adopt the "weighted average cost method" for their profit calculations whereby the price of inventories at the beginning of the period is partially reflected in the cost of goods sold. Under this method, when the prices of crude oil

In the processing industry, there is a declining trend of output prices in the first place against the background of technological innovation, and the business structure is that these price declines are more than offset by quantity factors and the declining trend in prices of parts and other inputs. In FY 2004, however, as materials prices shot up, input prices rose unusually, making price more negative than they would have been normally. Even under these conditions, processing firms managed to secure profits in FY2004 because they succeeded, as they did in FY2003, in minimizing increases in personnel expenses and other fixed expenses while continuing to enjoy a large positive quantity contribution, which conceptually includes shift of their products toward higher value added ones.

The same analyses cannot be implemented on the nonmanufacturing industries due to the lack of data. Nevertheless, some implication can be drawn from observations of profits, industry by industry. Among the nonmanufacturing industries that are believed to have a comparatively close relationship with manufacturing and overseas activities (Chart 24(1)), the current profits sales ratio of marine transport rose conspicuously against the background of the sharp rise in global commodity prices and the resultant strong demand for international transportation. While other nonmanufacturing industries also enjoyed steady increases in earnings, land transport was forced to post flat profits in both FY 2003 and FY 2004, because of higher fuel prices and its difficulty in passing them on under severe competition.

In sum, although the global economic expansion of 2003-2004 marked by the rapid growth of China worsened profit margins in some area both in manufacturing and nonmanufacturing, overall it functioned as a strong tailwind boosting the profits of Japanese enterprises through quantity effects that greatly surpassed the negative terms-of-trade effects.

---

and petroleum products both rise, profits tend to be bloated because the low price at the beginning of the period is partially reflected in the calculated profits. Please note that this “inventory valuation profit” is also included in the quantity factors.

(3) Firm Domestic Demand with the Easing of Structural Adjustment Pressures

The considerable positive contribution from quantity factors were not solely brought about by the overseas environment. Rather, continued firm domestic demand during the present economic recovery phase has also been an important factor. In fact, the trend toward improved profits can clearly be seen even at nonmanufacturing industries that are believed to have comparatively little spillover effect from external developments (Chart 24(2)). It is true that the background to this firm domestic demand includes the gradual strengthening of a virtuous business cycle with increased manufacturing industry capital investment which can ultimately be traced to overseas demand. Nevertheless, it is also true that as a uniquely domestic factor the various structural adjustment pressures represented by the “three excesses” with regard to debt, capacity and employment have receded, and that this has served as a positive factor for the business environment in wide-ranging fields including diverse nonmanufacturing industries.

(The “three excesses” recede)

First examining the ratio of interest-bearing debt outstanding to total assets (Chart 25(1)), at large enterprises overall this ratio gradually declined throughout the 1990s, and then the pace of decline accelerated from around the end of the 1990s. This indicates how enterprises, under the aforementioned pressures to improve their balance sheets, decreased labor share and engaged in other measures to generate profit, and used the resultant cash flow to repay interest-bearing debt. And this development was particularly prominent in materials and nonmanufacturing industries, which had been comparatively inferior in their financial positions. There was also a clear movement toward debt reduction from the end of the 1990s at small and medium enterprises, where the trend toward persistently high or rising debts had continued for longer than at the large enterprises. The interest coverage ratios, which indicate how many years of interest payments can be covered by one year’s current profits (Chart 25(2)), have been clearly rising in recent years at Japanese firms including small and medium enterprises as a result of low interest rates combined with debt reduction. This is another piece of evidence that the

burden associated with borrowings has greatly declined.

Debt reduction is fundamentally the obverse side of reducing unprofitable assets and excess personnel, which is confirmed by the Bank of Japan's *Tankan* survey which indicates that both excess capacity and excess employment have now been nearly completely eliminated (Chart 26). This elimination of excess capacity and employment reduces fixed expenses and contributes to the recovery in corporate earnings in itself, and also revives enterprises' ability to take risks and promotes forward-looking strategic behavior. In fact, capital investment increased for two consecutive years in FY 2003 and FY 2004, and another substantial increase is planned for FY 2005.[22] Enterprises are increasing bonus payments and the number of full-time employees, indicating that the trend toward an increase in employee income is becoming firmly established, which in turn is expected to support personal consumption more securely.

Regarding the influence of the various excesses on enterprise expenditures, we also examined the factors that affect the savings-investment balance of the corporate sector (calculated as savings minus investments), using panel data by industry for the estimation (Chart 27).[23] The results confirmed that enterprise expenditures are restricted as (a) expected growth rate declines, (b) the uncertainty of profits increases, (c) interest coverage ratio declines, (d) the interest-bearing debt ratio rises, (e) excess employment increases, and (f) excess capacity increases.

---

[22] According to the BOJ *Tankan* (June 2005 survey), the FY 2005 capital investment plans for all scale enterprises in all industries (on a basis including software but excluding land, which approximates the measurement under the GDP statistics) call for an 8.8% increase (compared with an actual increase of 5.1% in FY 2004).

[23] The balance of enterprise savings and investment = enterprise savings – enterprise investments under the definitions whereby retained earnings = total capital – (capital + capital reserves); enterprise savings = the increase or decrease in retained earnings + depreciation and amortization expenses; and enterprise investments = capital investments + land investments + inventory investments. The data were sourced from Financial Statements Statistics of Corporations by Industry (for all scale enterprises in all industries).

Items (c)-(f) concern the “three excesses,” and it seems that the improvements in these items during the present economic recovery led the corporate sector to gradually engage in forward-looking action, which in turn led to firmer domestic demand.

(Stabilization of the financial system)

The disposal of nonperforming loans by financial institutions, which has advanced in line with the reduction of excess debt in the corporate sector (Chart 28(1)), has brought stabilization in the financial system. This development also constitutes extremely important positive changes in the domestic demand environment.[24] Regarding these points, the Bank of Japan *Tankan* lending attitude DI shows that since the financial crisis of 1997-1998, despite strong monetary easing, the majority of enterprises, especially small enterprises, have perceived financial institutions as taking a “severe” lending stance (Chart 28(2)). This suggests a high likelihood that financial system weakness functioned as a factor restraining business fixed investment not only by suppressing enterprise funds procurement but also by psychological impacts.[25] Very recently, however, with the stabilization of the financial system this lending attitude DI has generally recovered the levels posted prior to 1997-1998.

---

[24] “Financial System Report: An Assessment of Financial Stability Focusing on the Banking Sector” (Bank of Japan; August 2005) summarizes the current conditions of the financial system including the points that banks have generally overcome the nonperforming loans problem and are regaining stable business conditions.

[25] For empirical research on how financial system weaknesses has functioned to restrain business fixed investment see, concerning large enterprises, the BOJ Research and Statistics Department *Working Paper Series* “The Effects of Monetary Policy on Firm Investment after the Collapse of the Asset Price Bubble: An Investigation Using Japanese Micro Data” (Takashi Nagahata and Toshitaka Sekine, May 2002) and, concerning medium enterprises, the Bank of Japan *Working Paper Series* “Bank Health and Investment: An Analysis of Unlisted Companies in Japan” (Shin-ichi Fukuda, Munehisa Kasuya and Jouchi Nakajima, February 2005).

(Recovery of the construction and real estate sector)

Under this environment, the recent recovery of economic activities in private construction and real estate attracts attention. The construction starts by floor area, which is the most used leading index for construction investment (Chart 29), bottomed out in 2002 and has been on a steady recovery trend ever since. During the prolonged stagnation following the collapse of the bubble economy, this index temporarily rose with the large decline in interest rates in 1996-1997 and again in 2000 with the concentration of urban redevelopment projects and the change in the regulation on opening of large outlets. This time, however, the firm construction investment is likely to continue longer than the previous two times as it is taking place across a wide range of industries without any industry-specific, and thus possibly temporary factors.

This recovery in construction investment can also be largely attributed to the advances that have been made in the adjustment of excess stock. A cyclical diagram of construction investment stock (Chart 30) shows that until the beginning of the 1990s there were high expected growth rates of 3-5% per year for the real value added generated by building construction.[26] Subsequently during the 1990s, because the expected growth rate greatly declined along with the collapse of the real estate bubble, the resultant excess continued to exert adjustment pressures on construction investment, which in fact declined almost every year. Over the past few years, however, because of the already very low investment levels, it has become possible for investment to increase even under negative expected growth rates.[27] The environment is now such that the investment recovery momentum may easily continue for a long time with even a minor improvement in the expected growth rate.

---

[26] The cyclical diagram is located at the area where dotted lines consistent with 3-5% expected growth rates are drawn.

[27] The diagram shows that at the end of FY 2004 the investment to construction stock ratio had declined to around 4%. Following the vertical line which indicates this level, it would be consistent for FY 2005 construction investment to increase even under a historically extremely low expected growth rate of -1- -2%.

In addition to the decline in the level of construction investment, in the process of land sales accompanying restructuring and the disposal of nonperforming loans, urban land prices have fallen to a level low enough to promote active land transactions. From the second half of the 1990s the regulations in urban and other areas on land use and on the floor area ratios were eased in phases, and the financing channels were diversified to include real estate investment trusts (REITs) and non-recourse real estate loans. In this manner, the adjustment in land prices advanced and an environment facilitating real estate investment was fostered, promoting a recovery in real estate related demand including urban redevelopment and condominium construction. As a result, publicly assessed land prices on weighted average basis (Chart 31)[28] began rising in Tokyo from 2003, and the nationwide weighed average is now generally bottoming out as well. Overall, it is likely that the recovery of domestic demand during the present economic recovery phase has been influenced to no small extent by the fact that land prices, although after painfully long period of adjustment since collapse of the bubble, had finally fallen to a reasonable level.

3. Implications for the Japanese Economy

(FY 2005 corporate earnings and the Japanese economy)

Summarizing the conditions up until FY 2004 presented above, exactly when enterprises' break-even points declined as a result of restructuring efforts, overseas economies expanded, particularly with the rapid growth in China, and domestic demand also began to become more broad-based gradually. Under these conditions, corporate earnings continued to greatly increase, rising to levels

[28] The rate of change in publicly assessed land values under the public statistics is the simple average of the rates of change at each sample estate. Under that formula, when the value of land worth ¥10,000 per square meter declines by 10% while the value of land worth ¥10 million per square meter rises by 10%, the overall rate of change is simply zero. Here, in order to eliminate this distortion, we used the value of each sample estate as a weight to reconstruct the price index.

surpassing those recorded at the peak of the bubble economy across a wide range of industries. However, there are several factors that may well cause a slowdown in the profit growth for FY 2005.

First, there have been both domestic and overseas supply-demand adjustments in IT-related fields from around the middle of FY 2004, and their influence has continued into FY 2005.

Second, the influence of China's policies to suppress economic overheating also began to emerge from around that same time. Coupled with the influence from the IT adjustment, this has resulted in a deceleration of exports from the second half of FY 2004, and supply-demand balance for goods has become less tight, especially in the basic materials area of overseas markets (Chart 32).[29]

Third, it is gradually becoming difficult for enterprises to continue suppressing fixed expenses as much as they have to date. A rapid pace of the rise in the part-time workers ratio observed in the last few years is apparently unsustainable, and in fact enterprises have recently begun increasing their employment of full-time workers. Moreover, continued increases in capital investment would work to increase enterprises' depreciation burden.

Thus, it is likely that many of the factors that have supported the increase in corporate earnings until FY 2004 will no longer contribute to boosting the earnings for FY 2005 to the same degree. Moreover, it is unclear how the sharp rise in oil prices will influence profits. Nevertheless, the bright side of the third factor above (the difficulty in continuing to suppress fixed expenses) is that the spillover effect on domestic demand from the cumulative increase in corporate earnings is now becoming clearer, after some time lag.

---

[29] The increase in the Chinese supply capacity for steel, chemicals and other materials sector items is apparently another factor contributing to the easing of the international supply-demand balance.

Examining business fixed investment to begin with, following the increase in FY 2004 driven by IT-related investment, the FY 2005 plans indicate that the overall momentum of increased capital investment is being maintained and expanding over a wider range of industries. With the confidence about the future gained from the progress in various types of adjustments and the continued economic recovery, enterprises are gradually changing to a more forward-looking stance in their risk-taking behavior. The analyses on the balance of enterprise savings and investment (Chart 27, above), which revealed the likelihood that the reductions of the "three excesses" have begun to stimulate enterprise expenditures, also indicated at the same time that enterprises' expected growth rates are an important determining factor for expenditure behavior. Regarding this point, according to the Annual Survey of Corporate Behavior implemented by the Cabinet Office each January (Chart 33), enterprises' expected demand growth rates for the industries that they belong to bottomed out in FY 2003 and have risen slightly, and under those conditions the growth rate in projected capital investment over the coming three years is rising, especially for the current fiscal year. Also, regarding the income transmission from enterprises to households, the rising trend of employee income is becoming established, and dividend payments are also clearly rising (Chart 34).

Because export and IT-related adjustment pressures are gradually easing[30] while domestic demand becomes increasingly firm, although the profit increase rate may ease substantially during FY 2005, profits are still very likely to remain at high levels. The BOJ *Tankan* indicates that FY 2005 current profits are expected to rise somewhat overall from the already high levels of the prior fiscal year (Chart 35). For example, the current profit to sales ratio among large enterprises in the

[30] Regarding this point, with the adjustment in IT-related fields and the decline in China's external absorption from the second half of last year through the first half of this year, manufacturing sector activities have weakened slightly accompanied by a minor inventory adjustment not only in Japan but also in the US and East Asia. Very recently, however, there are global signs that this mini adjustment phase is approaching an end. They include improved manufacturing-related indices in the US, fairly good earnings of the US high-tech sector, and a recovery in the exports of the NIEs.

manufacturing industry, which reached 5.94% in FY 2004, surpassing the previous record high of 5.75% posted in FY 1989, is expected to continue staying above the bubble peak, with both sales and profits slightly improving in FY 2005.[31] Taking all these aspects into consideration, while the rate of increase in corporate earnings has recently been easing, the self-sustaining mechanism whereby domestic demand and corporate earnings are coming to have a positive effect on each other appears to be becoming firmly established, albeit little by little.

(Changes in corporate behavior as shown by cash flow)

Compared with the ample cash flow, enterprise spending activity still remains cautious. Nevertheless, as explained above, it is also a fact that amid diverse environmental changes, forward-looking elements are gradually emerging in corporate behavior. Let us look at this from another angle: consolidated cash flow statements of listed enterprises (Chart 36).[32]

First, the Operating Cash Flow generated by regular enterprise activities peaked out in FY 2004, albeit still at a high level. A slight decrease in operating cash flow despite the continued rising in pre-tax earnings is in part because of a slight increase in corporation taxes. More fundamentally, however, this occurred because the working capital, categorized under Others, which had been declining through the previous year turned to an increase in FY 2004. So even when looking at the Operating Cash Flow alone, some change in corporate behavior is visible in the shift from funds saving to funds use.

Second, as a more important change, the Investment Cash Flow, which reflects

---

31 Because these figures come from the June *Tankan* survey, they most likely do not fully reflect the potential negative influence from the rises in oil prices since the summer. On the other hand, the large manufacturing enterprises' business plans assume a rather strong yen with the presumed exchange rate set at ¥103.95 per US dollar, and in that aspect the profit plans leave substantial room for upwards revision.

32 Data are only available from FY 1999, when Japanese enterprises became legally obliged to publicly disclose their cash flow statements.

developments in business fixed investment, clearly rose in FY 2004. The resulting differential between Operating Cash Flow and Investment Cash Flow still shows a substantial funds surplus in FY 2004, but the magnitude of the surplus is somewhat less than during the two previous fiscal years.

Third, the breakdown of the Financial Cash Flow, which captures the financial changes corresponding to the funds surplus,[33] shows that in FY 2004 while net repayments of interest-bearing debt were reduced, the return of funds to shareholders via share repurchases and dividend payments increased.[34]

Furthermore, examining these Financial Cash Flow developments by enterprise rating (Chart 37) indicates that at enterprises rated AA or higher the investment activities have basically matched Operating Cash Flow for many years, with only small net repayments of interest-bearing debts, suggesting that excess debt was never a big problem at these firms. Under these conditions, the return of funds to shareholders has expanded since profits rose in FY 2002, while developments in interest-bearing debt show that enterprises turned to become net borrowers from FY 2003. In this manner enterprise groups with good financial positions have started taking financial behavior that could contribute to higher leverage (higher debt ratios).

Meanwhile, even in FY 2004 over 60% of Operating Cash Flow was allocated to repayment of interest-bearing debt at enterprises rated BBB, which are just barely considered investment grade. Thus, for this category of firms, it seems that excess

---

[33] In Chart 36(1) the differential between Operating Cash Flow and Investment Cash Flow does not exactly match Financial Cash Flow. The deviation between the two implies the increase or decrease in cash on hand. In FY 2003, that deviation was comparatively large, indicating a substantial increase in cash on hand. In FY 2004, that deviation almost completely disappeared, indicating that the increase in cash on hand stopped.

[34] Here, the dividends reflected in the cash flow during FY 2004 are those for which the profit appropriation was fixed during FY 2004 (mainly, those under the FY 2003 profits), and dividend payments during FY 2005 are expected to increase even further (Chart 34, above).

debt may still be functioning as a factor that restrains spending activities.

Firms with a rating of A, which lies in between AA and BBB, reduced their net repayments of interest-bearing debt in FY 2004 and increased their allocation of profits to investment, representing the trend of the corporate sector overall.

Thus, while there are substantial differences in financial strategies among enterprises with different ratings, overall corporate behavior is changing from the stance toward giving top priority to reducing interest-bearing debt and thereby debt to capital ratio, which became apparent following the financial crisis of 1997-98, toward placing greater emphasis on making investments, which is the wellspring of future profits, and on the return of funds to shareholders. While these developments are taking place amid still suppressed scale of investment in comparison with ample cash flow, it may be noteworthy that these changes are consistent with the recent trend toward a corporate governance with greater emphasis on shareholders.

(Greater earnings power and expectations of its sustainability)

As we have seen from various perspectives, a virtuous cycle whereby the high level of corporate earnings accumulated to date generates forward-looking strategic behavior, which in turn once again supports corporate earnings, is gradually becoming established. Also the presence of newly listed enterprises is rapidly increasing as can be seen in a substantial gain over the past two years in the market capitalizations of the Tokyo Stock Exchange Mothers and the Osaka Securities Exchange Hercules, the markets for emerging enterprises (Chart 38).[35] With the rectifications of a huge sum of nonperforming loans and various other imbalances, the Japanese economy may finally be emerging from the prolonged stagnation that continued for over a decade following the collapse of the bubble economy. Nevertheless, the Japanese economy is still facing the following grave

[35] The scales of these market capitalizations are still quite small considering, for example, that the total market capitalization of firms listed on the First Section of the Tokyo Stock Exchange is on the order of ¥400 trillion. Nevertheless, the growth is remarkable.

issues.

The first issue is that the declining fertility rate and the aging of society will advance. The total population of Japan is projected to start declining from 2007. The core labor force (the population segment 20-64 years old) already began to decline slightly several years ago, and is expected to decrease by about 1% per year over the next decade of the 21st century. Ceteris paribus, this decline in the working-age population will become a factor that pulls down the growth potential of the Japanese economy in terms of both labor supply and domestic demand. The issues of who will pay for the increased medical expenses and pension benefits accompanying the aging of society and how this burden will be covered remain unresolved.[36]

Second is the fiscal deficit problem which has ballooned, in part, from the economic stimulus measures implemented since the 1990s. While the budget deficit in the primary balance (fiscal balance excluding government bond interest payments) stopped increasing from FY 2002, it still remains at a high level of around 5% of nominal GDP. Because budget deficits are continuing, the outstanding government debt – which reached about 170% of GDP at the end of FY 2003 – will continue to rise for some time.

Thinking about these issues in broad terms from a rather long-term perspective, increase in the public burden on the household sector through taxes and net social insurance payments seems inevitable. The future vitality of Japanese enterprises holds the key for whether employee income and the return on financial assets will be sufficient for the household sector to withstand this increase in the public financial burden. Especially considering the decline in the working population over the long term, the route whereby the earnings power of Japanese enterprises supports household income via financial assets may gradually become more important. In fact, an empirical analysis shows that personal consumption has

---

[36] For a discussion of these issues from a broad-ranging perspective see, for example, the Bank of Japan *Working Paper Series* "Demographic Changes in Japan and their Macroeconomic Effects" (Takashi Kozu, Yoshiko Sato and Masakazu Inada; Sept. 2003).

statistically significant long-term relation not only with real employee compensation but also with real net financial assets (Chart 39(1)). Of these, the value of real net financial assets is strongly influenced by stock prices (Chart 39(2)). Over the long term, increased enterprise value is an important factor supporting households' economic activities.

Although, as already mentioned, income transmission from corporate to household sector is now gradually becoming clear, the rate of increase in employee incomes is still rather low. Although dividends paid by enterprises are increasing, it appears that dividends still account for just a small fraction of household disposable income based on FY 2003 national accounts, the latest available data (Chart 40).[37] The prolongation of low interest rates and the large decline in net financial income can ultimately be attributed to the continued insufficient strength of the enterprise sector overall in generating profits under higher funds procurement costs. While stock prices have moved up a bit very recently, the market has yet to gain strong confidence that Japanese enterprises' middle to long-term earnings power has distinctly risen.

ROA and ROE figures, which are broadly used as global investment yardsticks, indicate that in FY 2004 the earnings power of Japanese enterprises recovered to a level surpassing the two previous peaks (Chart 41).[38] Nevertheless, this level remains low compared with that in the US during the 1990s, when high economic growth and rising stock prices formed a virtuous cycle.

---

[37] Of course the fundamental reason why households receive little dividend income is that household financial assets are mostly cash and deposits, while shares have just a small weight. The Flow of Funds statistics shows that as of the end of March 2005 cash and deposits account for 54.8% of household financial assets, while shares and other equities and investment trusts account for merely 11.3%. These figures are completely opposite to those in the US, where the former account for 13.2% and the latter for 46.6%. So advancing an environment which will encourage households to diversify their financial assets into shares and equity-related products is also an important issue.

[38] The discussion here covers the manufacturing sector, where it is easy to compare Japan with the US.

For enterprises to continue generating high profits, on average, over a long period of time, it is essential that they ceaselessly cut off unprofitable segments and flexibly embrace the challenges into fields where high profits can be expected. Increases in enterprise value require not only efficiency, but also growth. Given the limits to the pace of domestic market growth with the declining fertility rate and the aging of society, business strategies which position the global market as the source of earnings growth are becoming important factors for many, if not all, Japanese enterprises. However, this brings Japanese firms into fierce competition with global enterprises from other nations, and therefore swift management is called for to discern changes in the environment and adjust strategies in response.

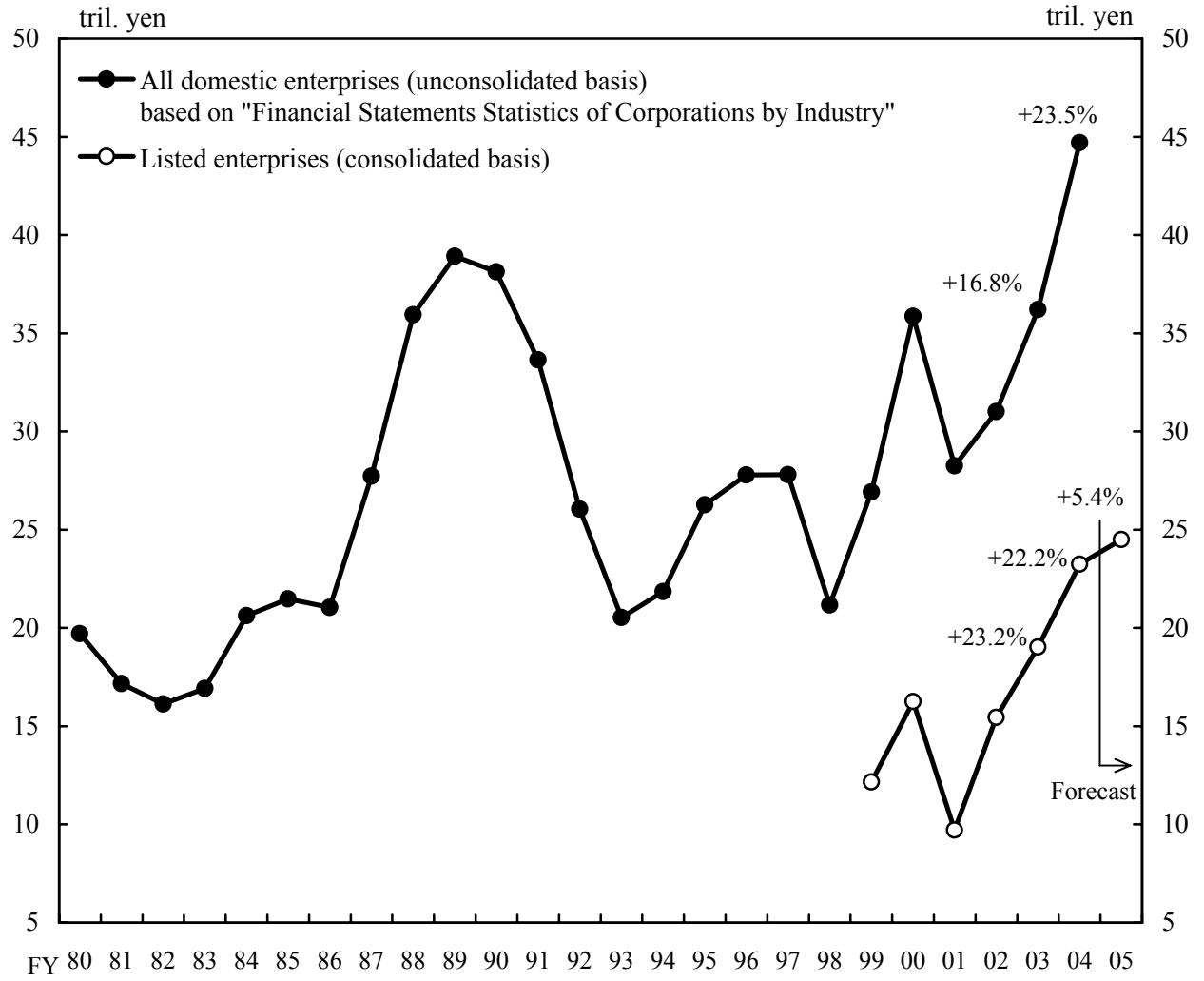
Merger and Acquisition (M&A) activities, for example, are one effective means of implementing that sort of dynamic allocation of resources. In fact, the number of M&A cases involving Japanese enterprises (Chart 42(1)) rose sharply once around the year 2000 along with the advance of tax and legal reforms, and has increased once again over the past 1-2 years.

However, not a small percentage of Japanese M&A cases to date have been implemented as last resort measures at firms that have fallen into difficulties, or been motivated by accounting gimmicks, for example, to deal with unrealized gains adroitly. Also, an international comparison of the ratio of total M&A value to nominal GDP (Chart 42(2)) shows that while the level of activity in Japan is equivalent to that in Germany, it stands far behind that in nations such as France, the US and the UK. Further progress in institutional improvement is expected in FY 2006, when Japan's new Company Law comes into effect and more transparent accounting standards become applied. Of course, M&A activities entail considerable risks and have not always been successful overseas. Nevertheless, increases in M&A activities and the expansion of potential opportunities would intensify healthy competition over the pursuit of higher value of companies.

It cannot be denied that the large improvement in corporate earnings witnessed over the past 2-3 years was to some extent helped by the fortunate combination of

two special conditions: enterprises' strong sense of crisis and the remarkably good external economic environment. Yet even if so, the resultant acceleration of debt repayments and other adjustments left the companies with enhanced level of management freedom, which in itself is a highly meaningful consequence. Over the next 2-3 years, whether Japanese enterprises can take advantage of this opportunity to maintain and further strengthen earnings power, and whether the structural reforms will be further progressed and thereby contribute to stimulating vitality of the corporate sector, will be critical for the future of the Japanese economy.

Current Profits

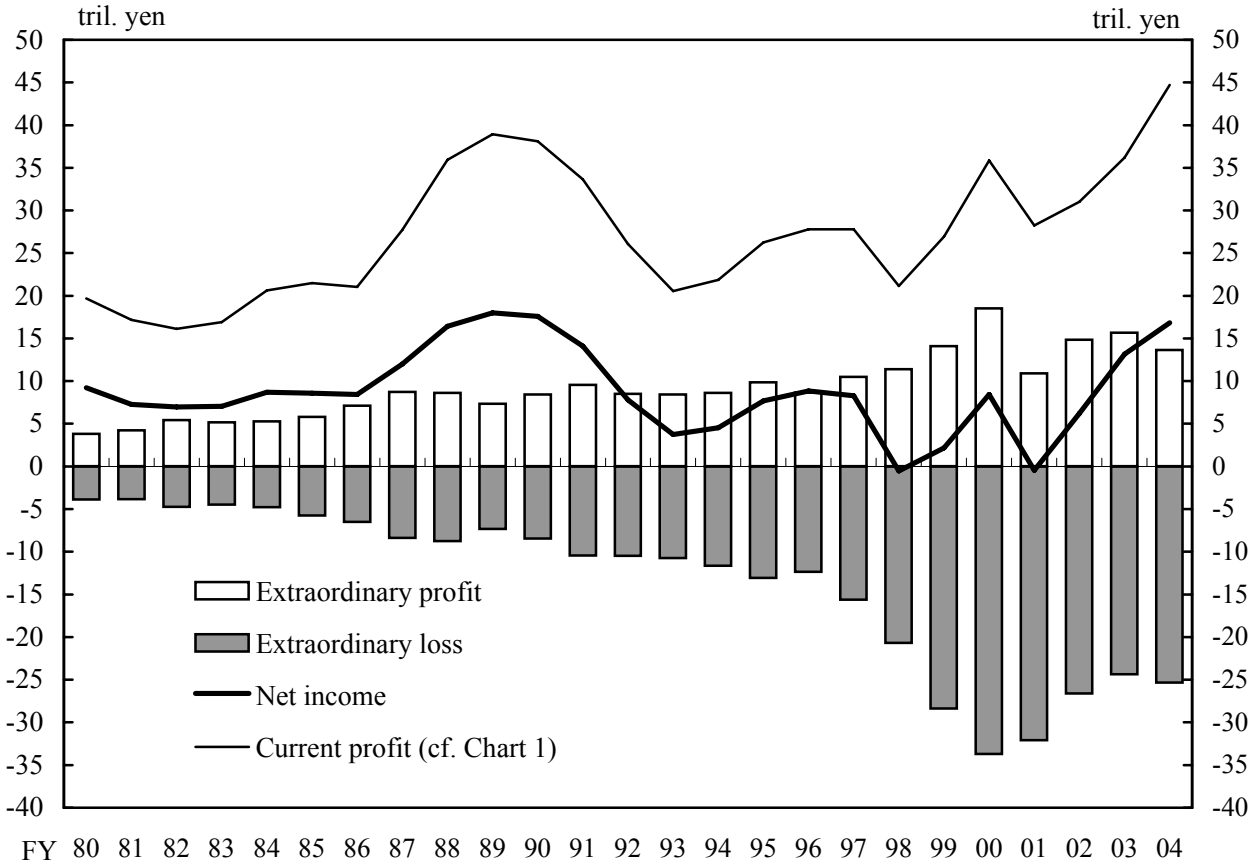


Notes: 1. Data are for non-financial corporations.
2. Numbers shown in the graph are year-on-year changes.
3. Data for listed enterprises, which cover 345 enterprises (217 manufacturing and 128 nonmanufacturing enterprises), are based on information available as of September 2005.

Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually";
Nomura Securities Co., Ltd.

Chart 2

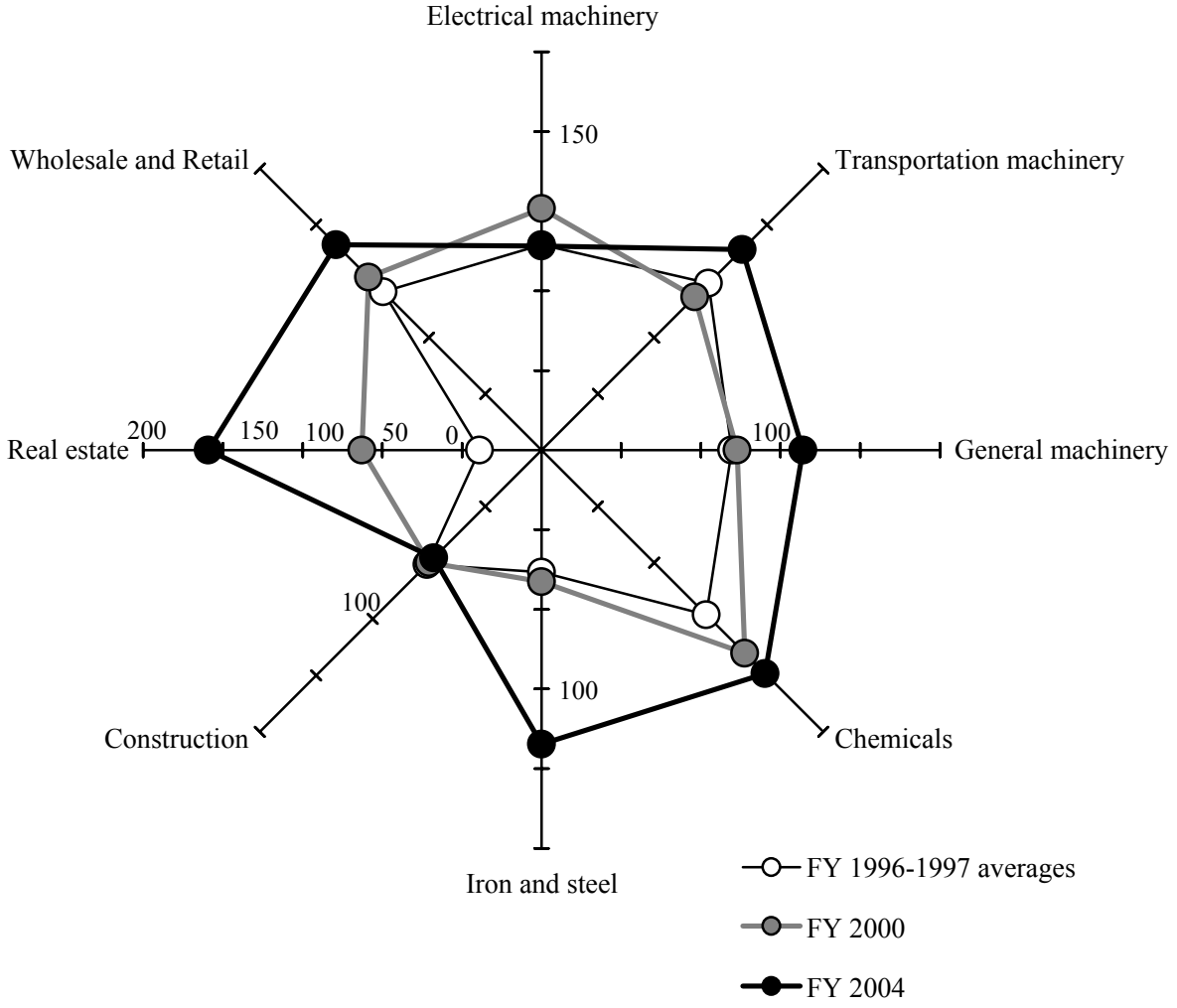
Net Income



Note: Data are for all scale enterprises in all industries.

Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually."

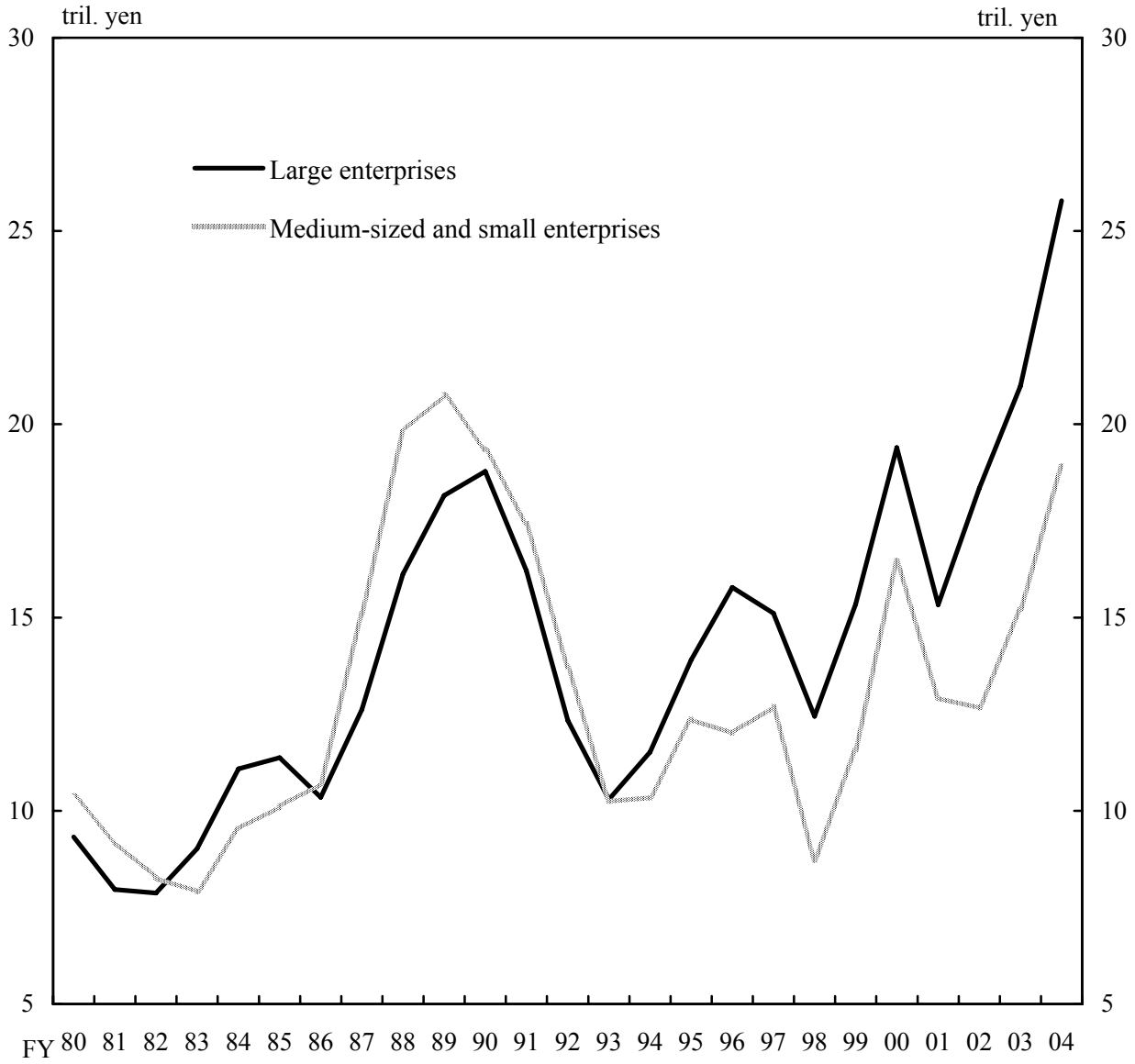
Comparison of Present and Past Current Profits



Note: Each figure is calculated as an index comparing with the peak of each industry's current profits during the "bubble era", which is equal to 100. The peak year of Chemicals, Iron and steel and Real estate is FY 1989, that of Electrical machinery, Transportation machinery, General machinery and Wholesale and Retail is FY 1990 and that of Construction is FY 1991.

Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually."

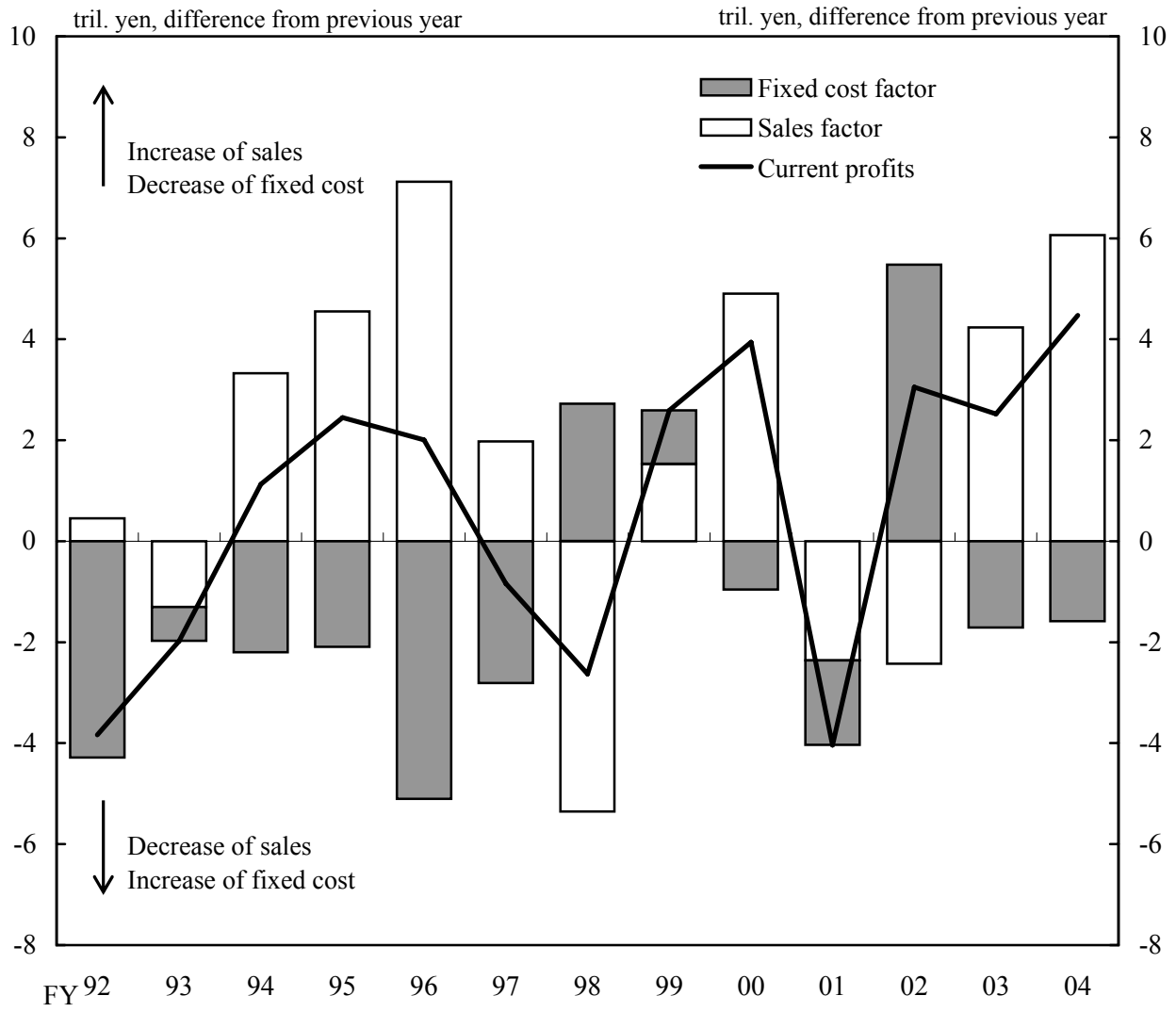
Current Profits by Enterprise Scale



Note: Data are for all industries.

Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually."

Factor Analysis of Current Profits at Large Enterprises



Notes : 1. Data are for large enterprises excluding electric and gas utilities.

2. · Δcurrent profits = Δsales - Δvariable cost - Δfixed cost

quantity factor | fixed cost factor

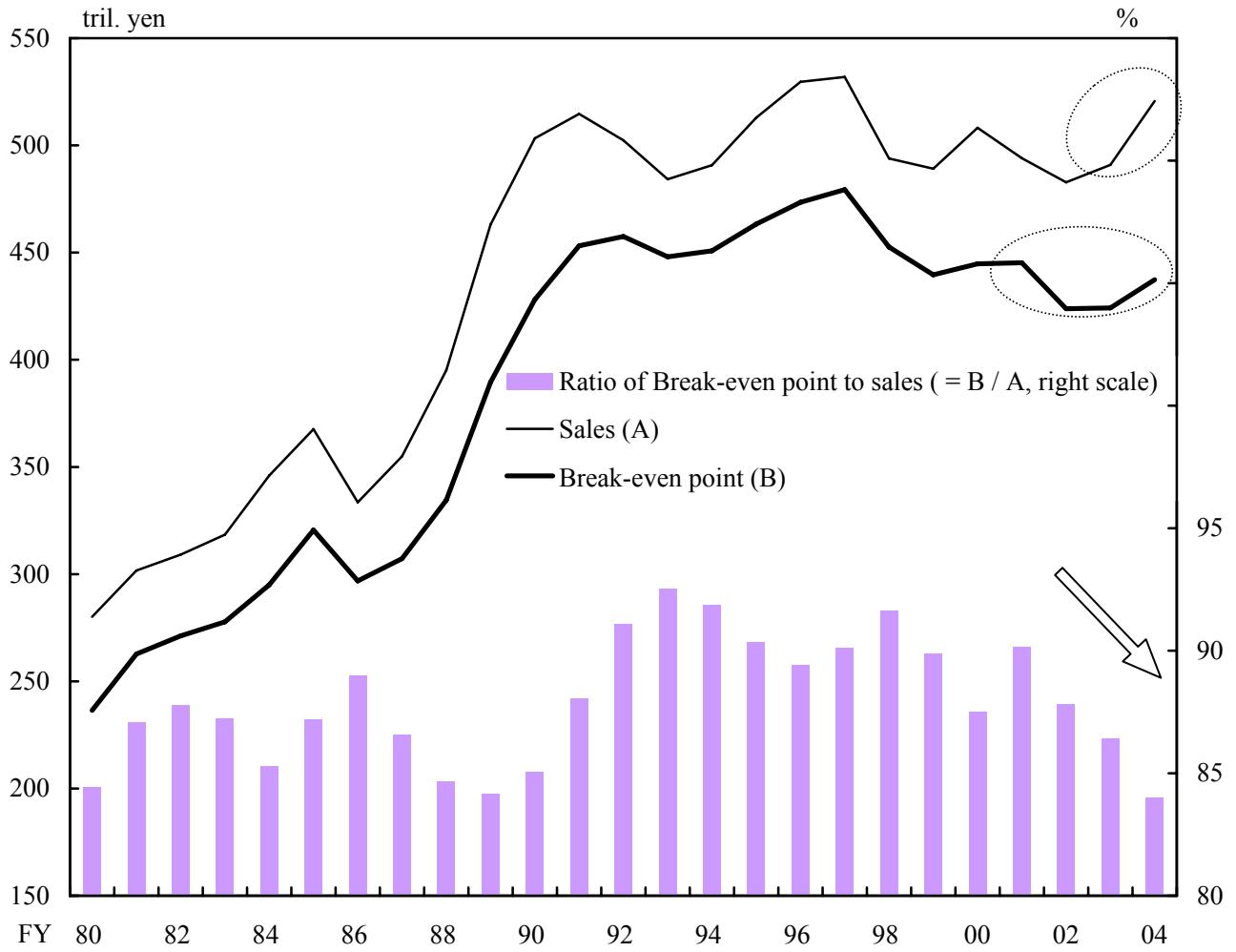
· Fixed cost = Personnel expenses + depreciation and amortization expenses + net non-operating expenses + selling and general administrative expenses × 0.7

· Variable cost = current profit - fixed cost

3. Selling and general administrative expenses are multiplied by 0.7 to avoid double calculation of personnel expenses and depreciation and amortization expenses. According to data of listed enterprises, about 30% of the former are recognized as the latter.

Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually."

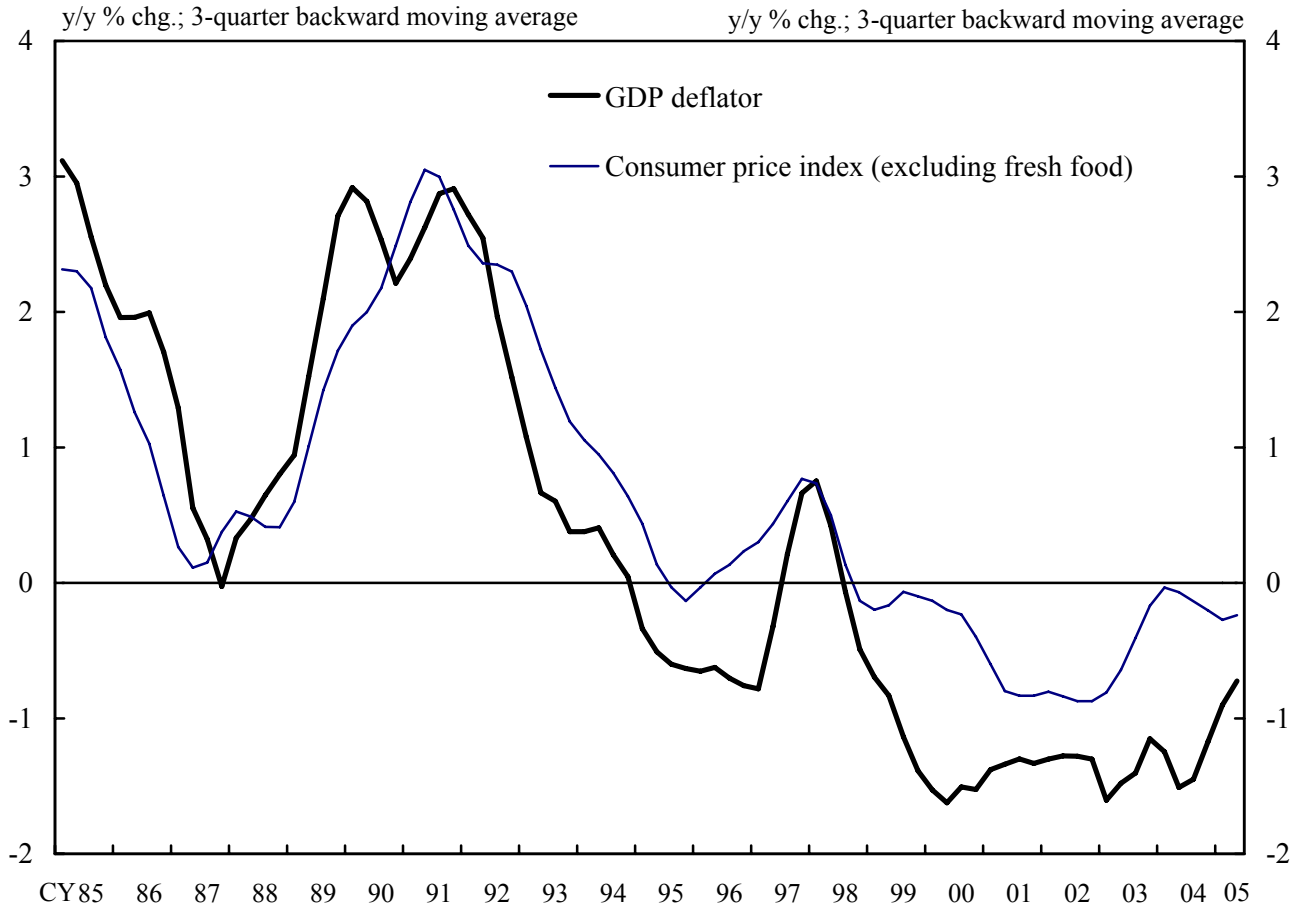
Break-even Point at Large Enterprises



Notes: 1. Data are for large enterprises excluding electric and gas utilities.
2. Break-even point = fixed cost / marginal profit ratio.
3. Marginal profit ratio = 1 - variable cost ratio = 1 - (sales - fixed cost - current profit) / sales.
(See notes in Chart 5 for the definition of fixed cost).

Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually."

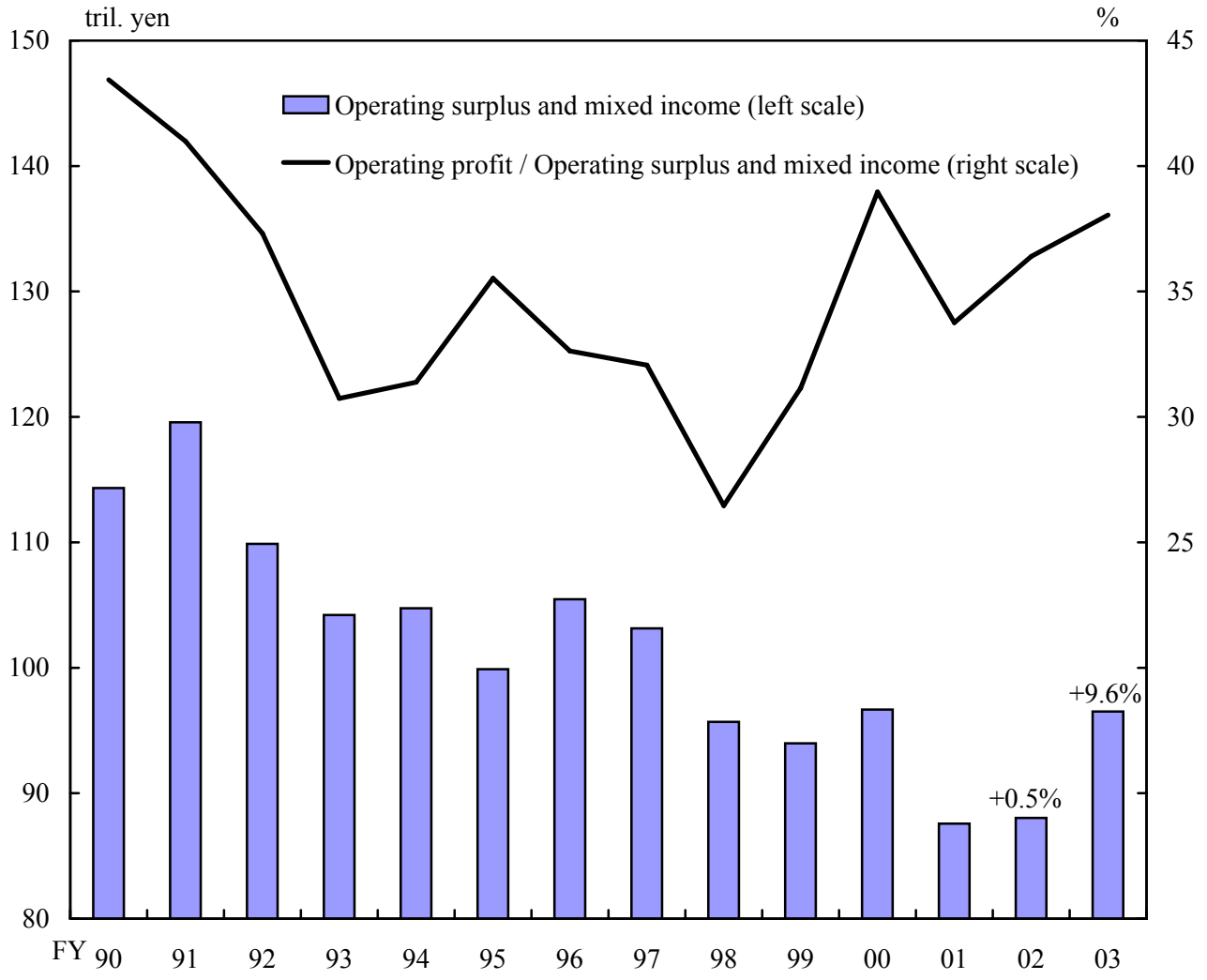
Inflation



Notes: 1. The GDP deflator for Apr.-Jun. 2005 is based on the 1st preliminary quarterly estimates of GDP.
2. The consumer price index is adjusted for changes in the consumption tax rate.

Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index";
Cabinet Office, "National Accounts."

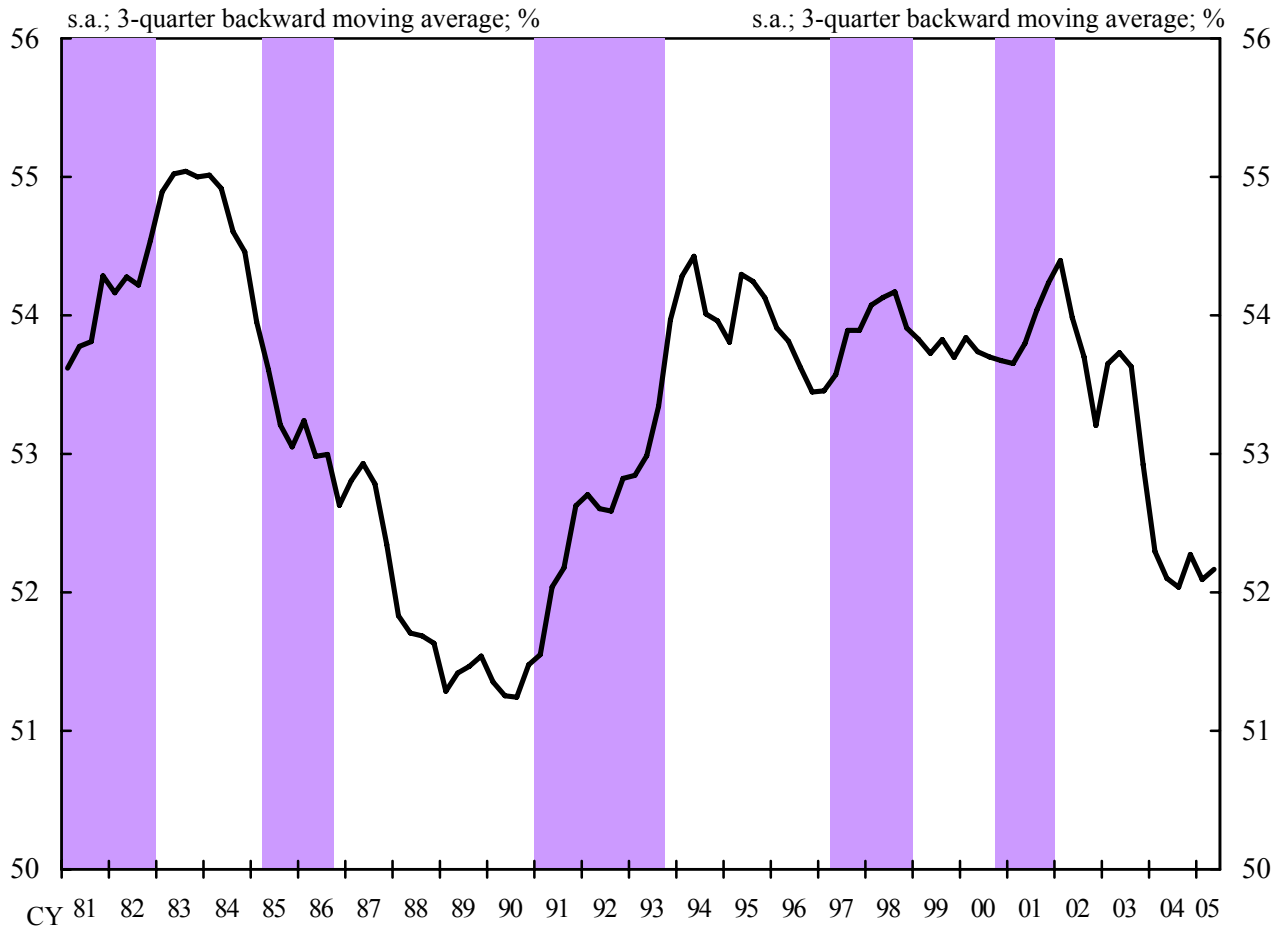
Corporate Profit and Operating Surplus and Mixed Income



Notes: 1. Numbers in the graph are year-on-year changes.
2. Operating profit is based on *Financial Statements Statistics of Corporations by Industry, Annually* .

Sources: Cabinet Office, "National Accounts"; Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually."

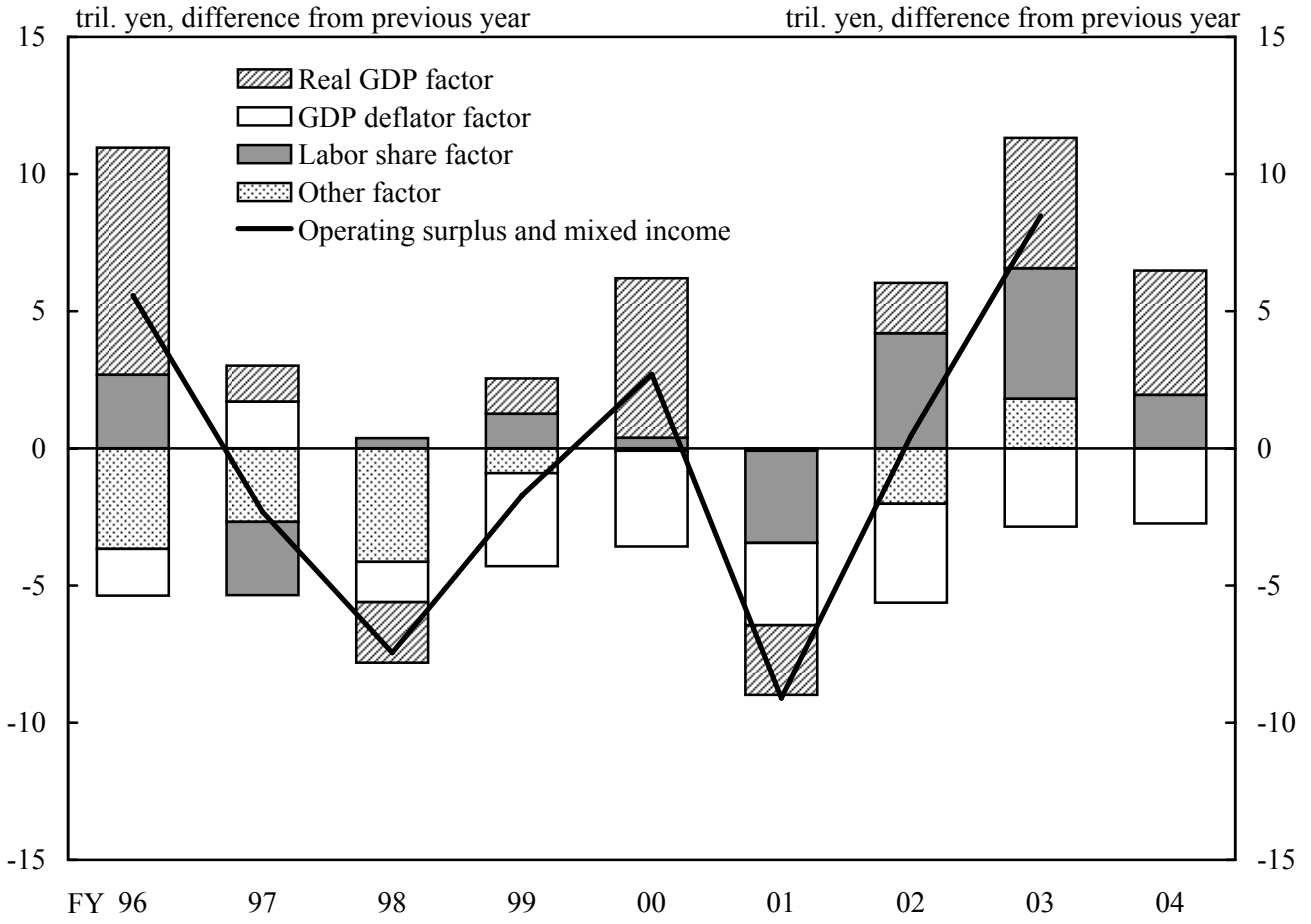
Labor Share



Notes: 1. Labor share = compensation of employees / nominal GDP.
2. The figure for Apr.-Jun. 2005 is based on the 1st preliminary quarterly estimates of GDP.
3. Shaded areas indicate recessions.

Source: Cabinet Office, "National Accounts."

Factor Analysis of Operating Surplus and Mixed Income



Notes : This factor analysis of operating surplus and mixed income is based on the method below:

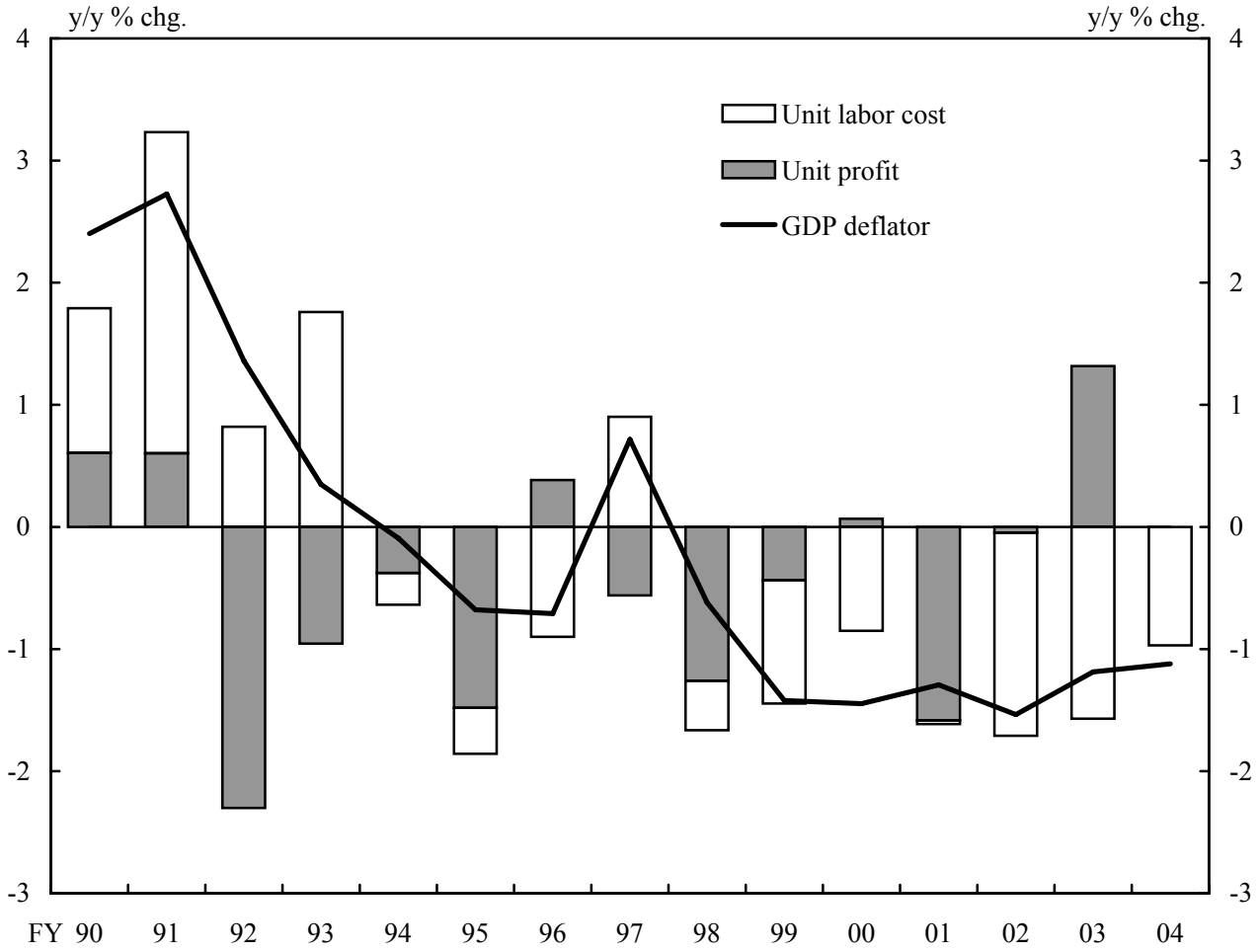
1. Operating surplus and mixed income is divided into real GDP factor, GDP deflator factor, labor share factor and other factor as follows:

   $\pi = A \times B \times C - D$

   (π: operating surplus and mixed income, A: real GDP, B: GDP deflator, C: 1 - labor share, D: other)
2. Differences in π from its value in the previous year can be broken down into component differences attributable to changes in each of the right-hand-side variables above.
3. "Other" refers to the difference attributed to changes in depreciation and amortization, indirect taxes, etc. This factor is calculated as the total difference minus the sum of the differences attributed to factors for A, B and C.
4. FY 2004 data are available for A, B and C but not for π and D, so FY 2004 data for π and D are not shown in this graph.

Source: Cabinet Office, "National Accounts."

Factor Analysis of GDP Deflator

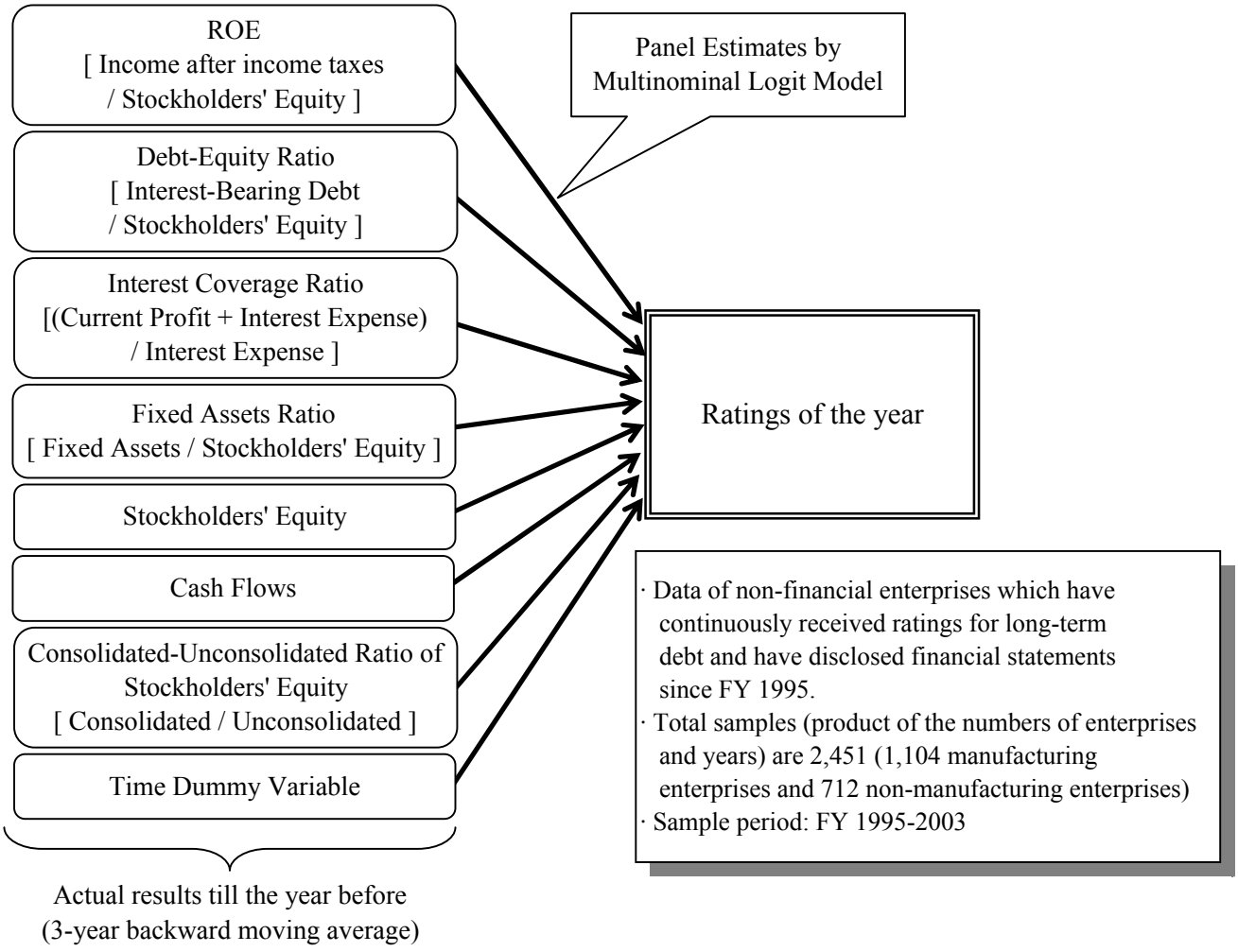


Notes: 1. Unit labor cost = compensation of employees / real GDP.
2. Unit profit = operating surplus and mixed income / real GDP.
Differences between line graph and bar graph result from of consumption of fixed capital, taxes on production and imports, subsidies and statistical discrepancies.
3. FY 2004 data are available for compensation of employees but not for operating surplus and mixed income, so the FY 2004 unit labor profit is unknown.

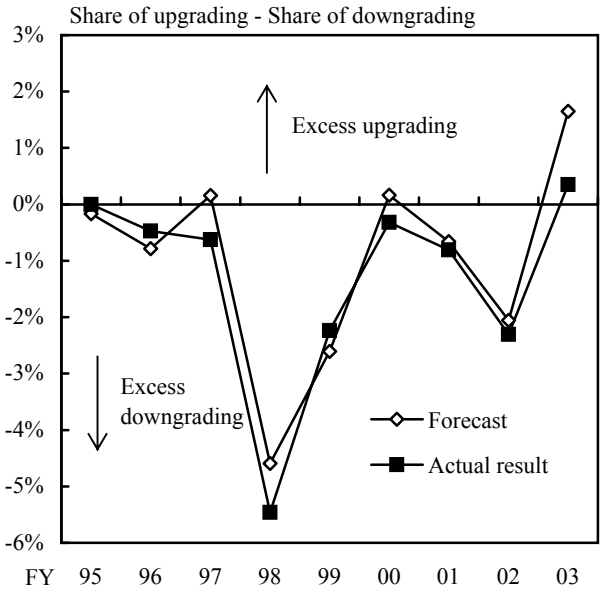
Source: Cabinet Office, "National Accounts."

Determinants for Ratings

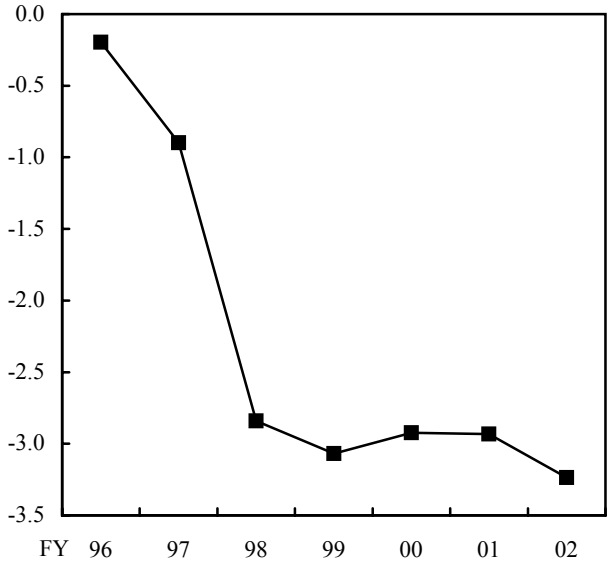
(1) Estimate of the rating function



(2) Estimation results



(3) Parameter for time dummy variable

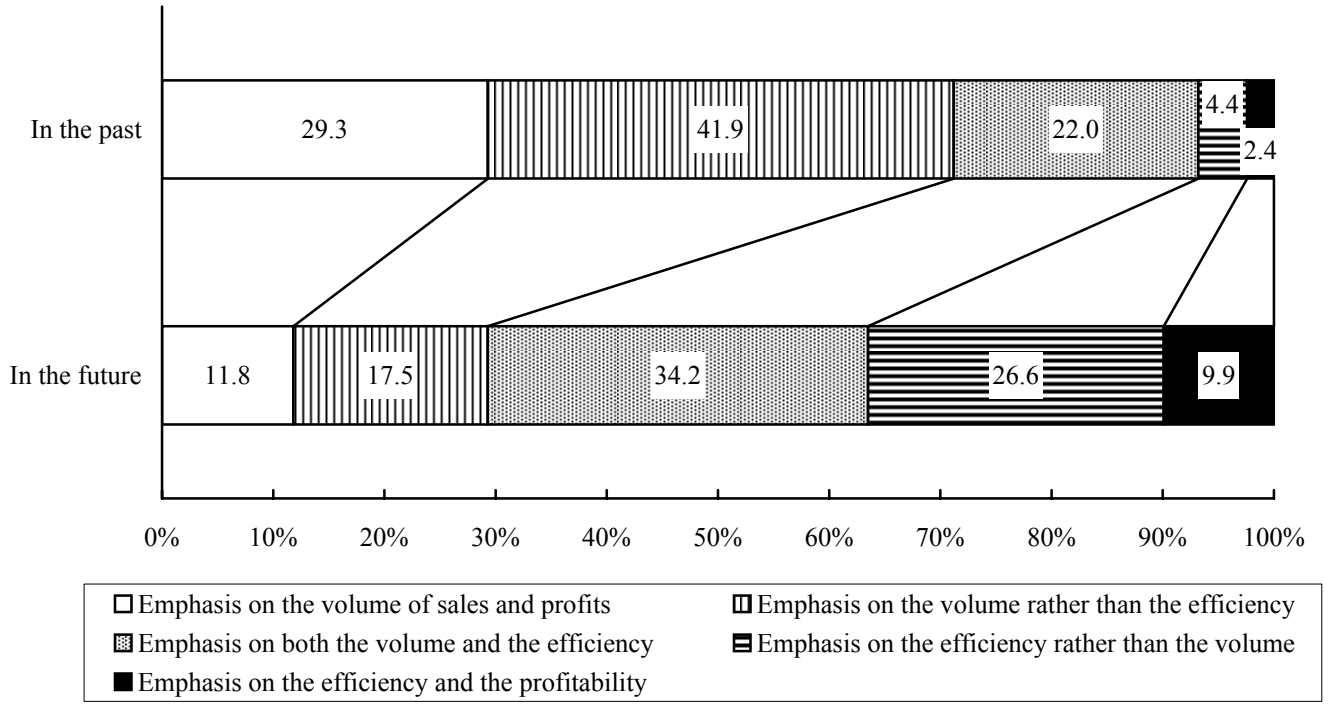


Note: The smaller the parameter is, the lower the rating is

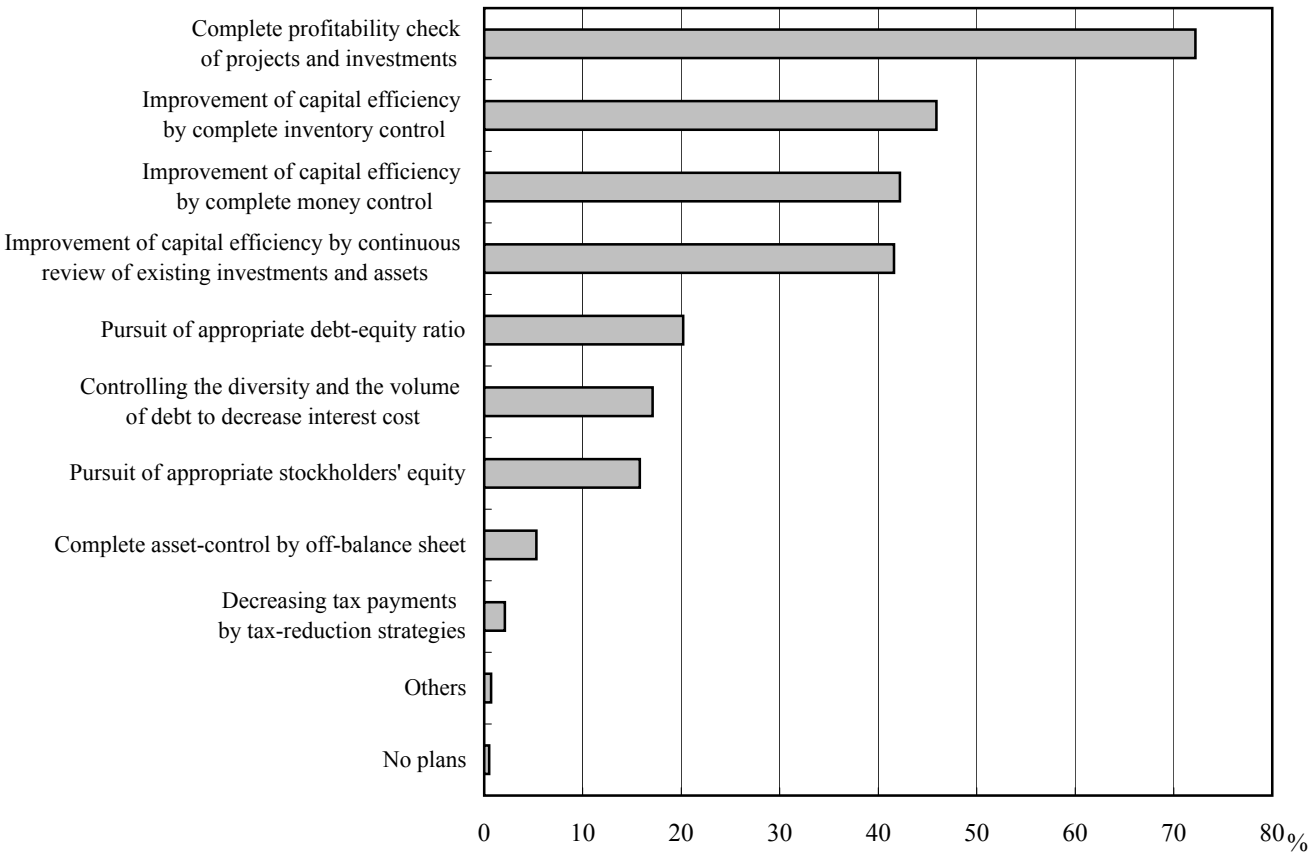
Sources: Nikkei Financial QUEST; Moody's Investors Service Inc.

Managers' Attitude toward Capital Efficiency

(1) Scale or efficiency



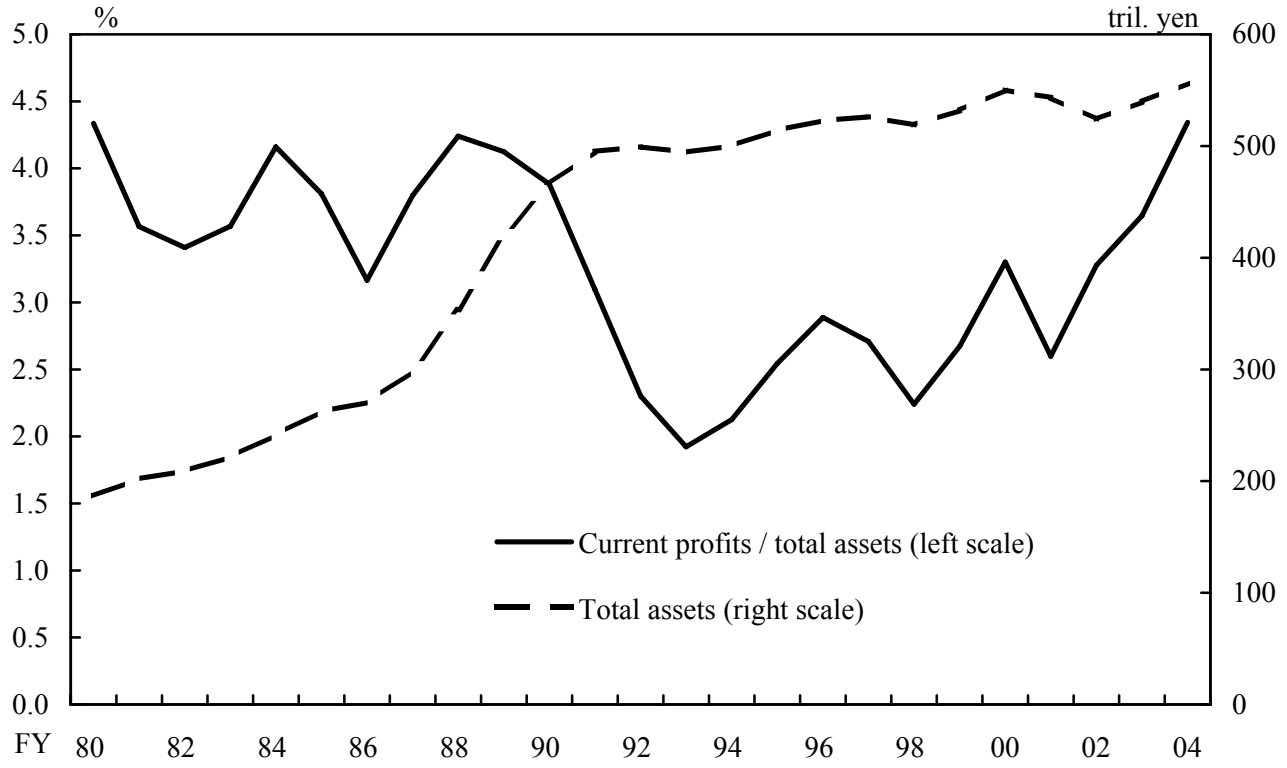
(2) Financial strategies to improve profitability and capital efficiency



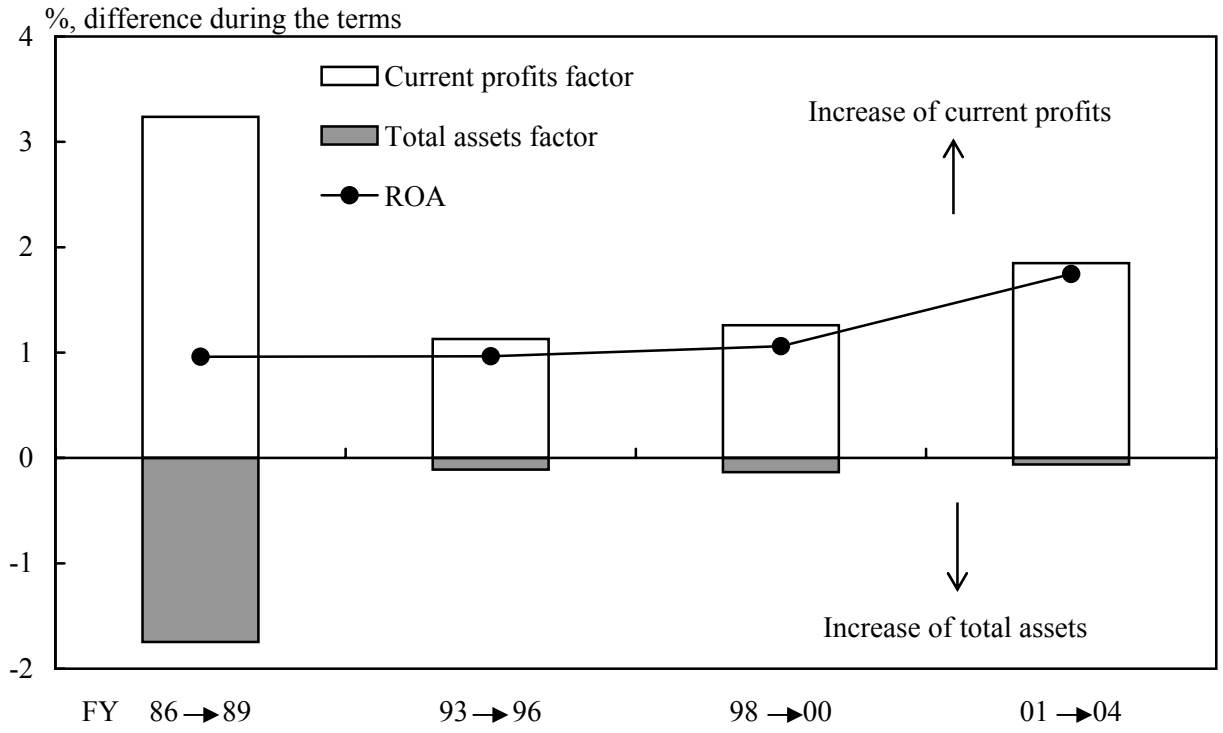
Source: Cabinet Office, "Annual Survey of Corporate Behavior FY 2001."

Return on Assets

(1) Return on Assets



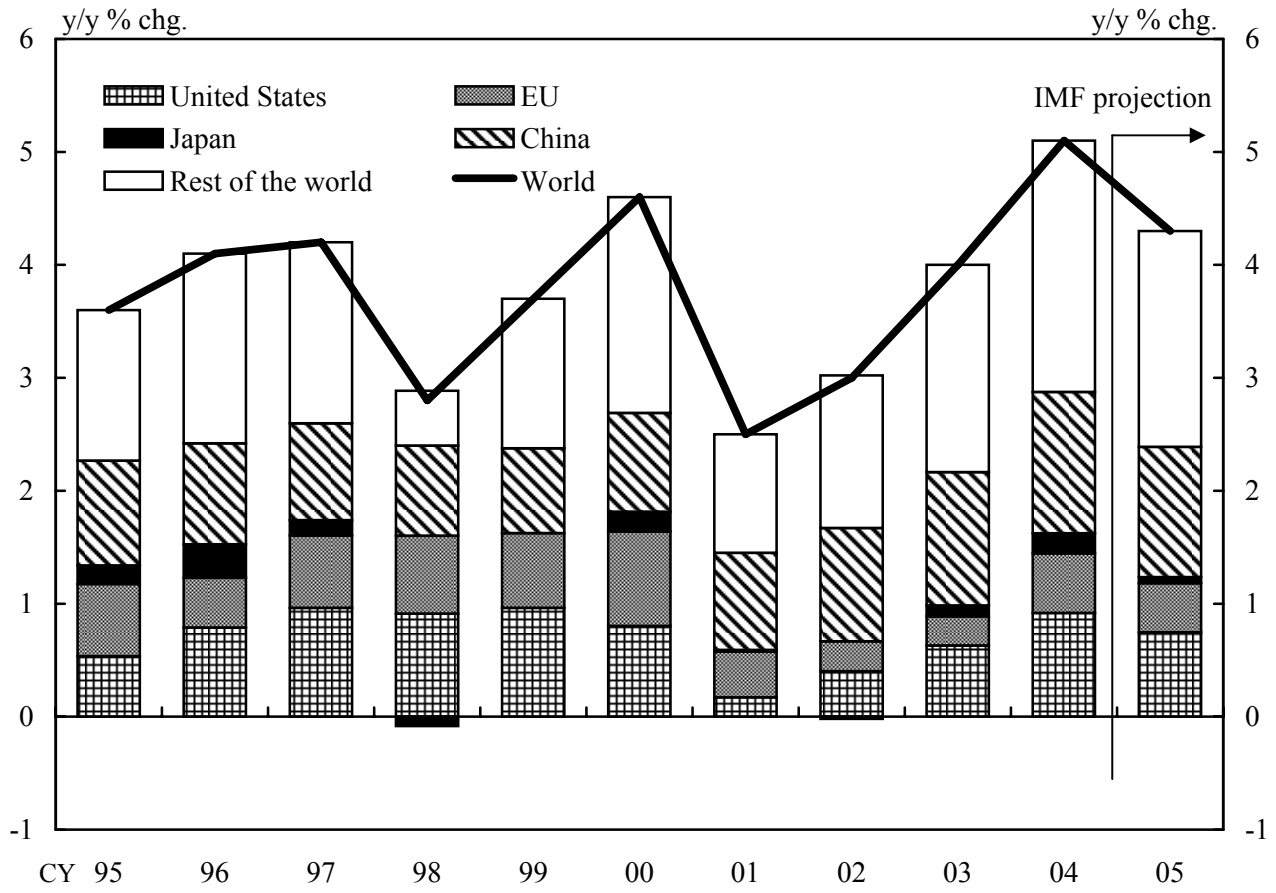
(2) Comparison of the terms



Note: Data are for large enterprises excluding electric and gas utilities.

Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually."

World Economic Growth

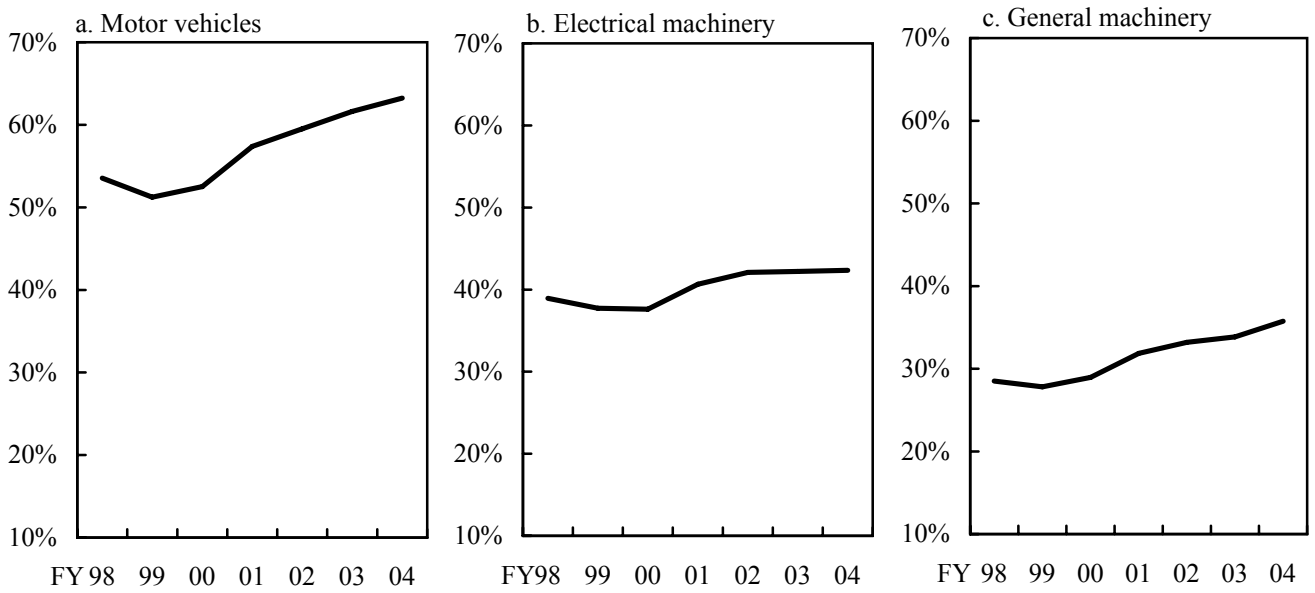


Note: Based on IMF's PPP shares of GDP.

Source: IMF, "World Economic Outlook."

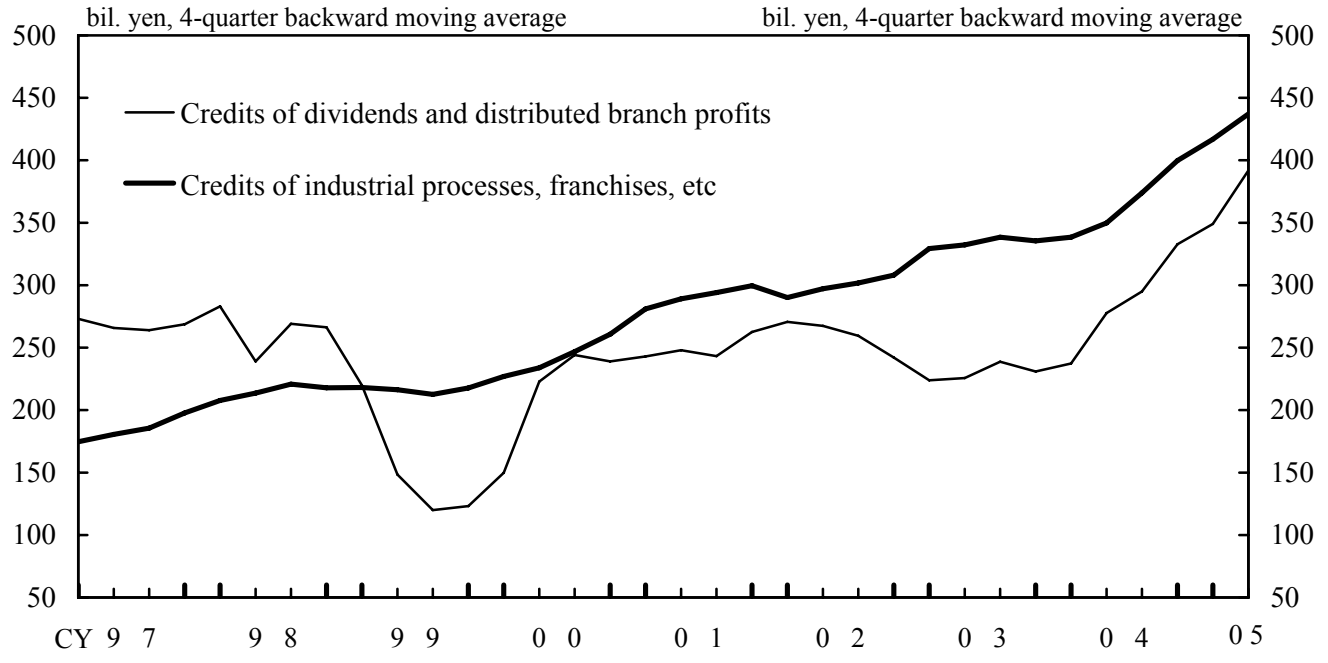
Sales of Overseas Subsidiaries

(1) Ratio of overseas sales to consolidated sales



Notes: 1. Figures are based on the enterprises disclosing geographical segment data continuously since FY 1998 (8 motor vehicle, 116 electrical machinery and 71 general machinery enterprises).
2. Ratios are defined as overseas sales in regional segment data divided by total sales.

(2) Profit return to the parent company



Sources: Nikkei Financial QUEST; Bank of Japan, "Balance of Payments Monthly."

Reorganization of Basic Materials Industry

Before reorganization **After reorganization**

(1) Iron and Steel

Share of production, %

Nippon Steel	25.9
NKK	10.8
Sum of top 2 companies	36.7
Kawasaki Steel	10.6
Sumitomo Metal Industries	10.0
Kobe Steel	5.8
Tokyo Steel	4.0
Nisshin Steel	3.6

Share of production, %

Nippon Steel	27.2
JFE	24.3
Sum of top 2 companies	51.5
Sumitomo Metal Industries	8.6
Kobe Steel	6.6
Tokyo Steel	3.5
Nisshin Steel	3.1

(2) Gasoline

Share of sales, %

Nippon Oil	16.3
Idemitsu Kosan	14.2
Showa Shell Sekiyu	12.7
Sum of top 3 companies	43.2
Cosmo Oil	11.7
Japan Energy	10.5
Mitsubishi Oil	8.3
Mobil Oil	7.8
Esso Oil	7.0
General Sekiyu	5.6
Kygnus Sekiyu	2.2

Share of sales, %

Nippon Oil	22.7
ExxonMobil	19.2
Showa Shell Sekiyu	14.0
Sum of top 3 companies	55.9
Idemitsu Kosan	14.0
Cosmo Oil	11.0
Japan Energy	10.2
Kygnus Sekiyu	2.4
Kyusyu Oil	1.9

(3) Cement

Share of production, %

Chichibu-Onoda Cement	22.8
Sumitomo Osaka Cement	17.8
Nihon Cement	17.4
Sum of top 3 companies	58.0
Mitsubishi Materials	13.8
Ube Industries	11.5
Tokuyama	6.2
Aso Cement	2.9

Share of production, %

Taiheiyo Cement	37.4
Ube-Mitsubishi Cement	27.0
Sumitomo Osaka Cement	17.4
Sum of top 3 companies	81.8
Tokuyama	6.1

(4) Polystyrene

Share of shipments, %

Asahi Chemical Industry	24.8
Japan Polystyrene	14.5
Denki Kagaku Kogyo	13.7
Sum of top 3 companies	53.0
Mitsubishi Chemical	13.1
Idemitsu Petrochemical	11.5
Nippon Steel Chemical	9.9
Dainippon Ink & Chemicals	8.6
Daicel Chemical Industries	3.9

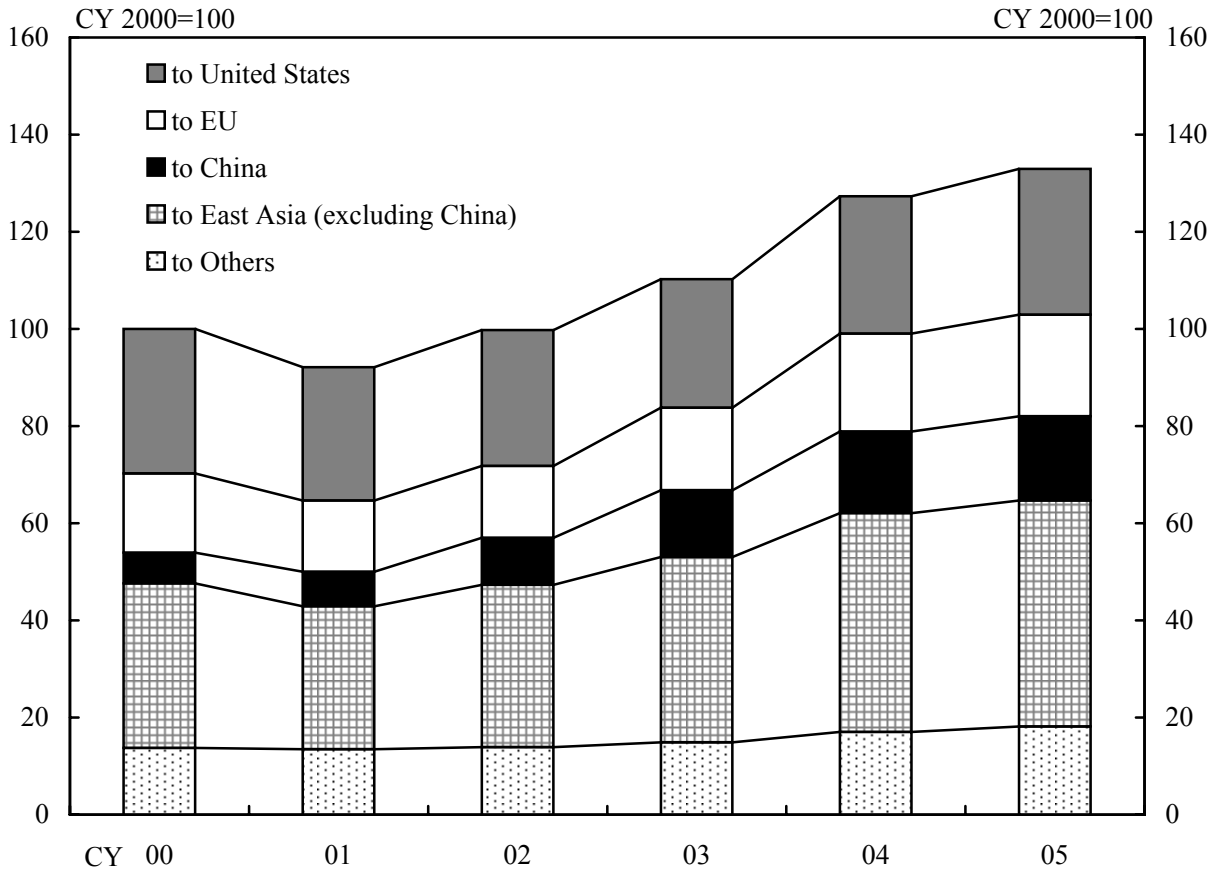
Share of shipments, %

PS Japan	44.1
Toyo Styrene	28.7
Japan Polystyrene	17.3
Sum of top 3 companies	90.1
Dainippon Ink & Chemicals	9.9

Notes: 1. Data before reorganization: iron and steel and gasoline are based on FY 1997, while cement and polystyrene are based on CY 1997.
2. Data after reorganization: iron and steel is based on FY 2003, gasoline and cement are based on CY 2003, while polystyrene is based on CY 2004.

Source: Yano Research Institute, "Japan Market Share Dictionary."

Real Exports

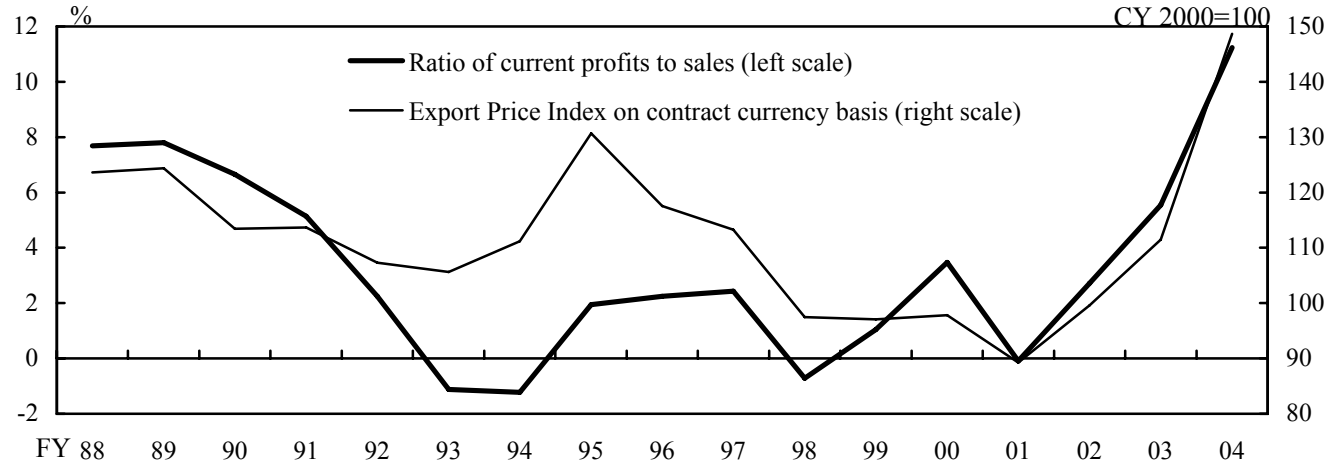


Notes: 1. Figures for CY 2005 are those of January-June in terms of annual amount.
2. Data for East Asia (excluding China) are those for NIEs and ASEAN4.

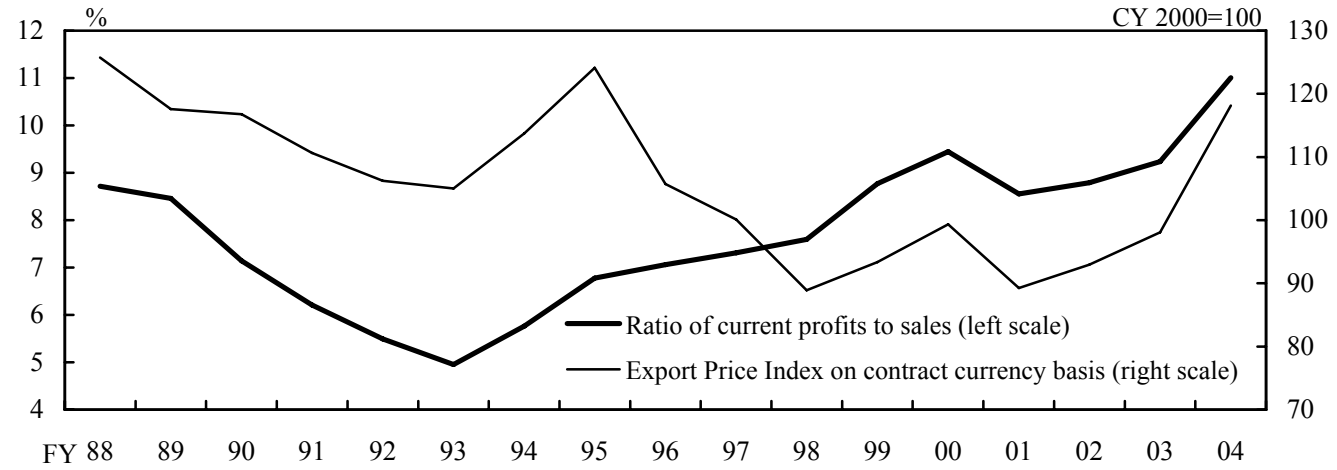
Sources: Ministry of Finance, "The Summary Report on Trade of Japan";
Bank of Japan, "Corporate Goods Price Index."

International Commodity Prices and Profits of Basic Materials Industries

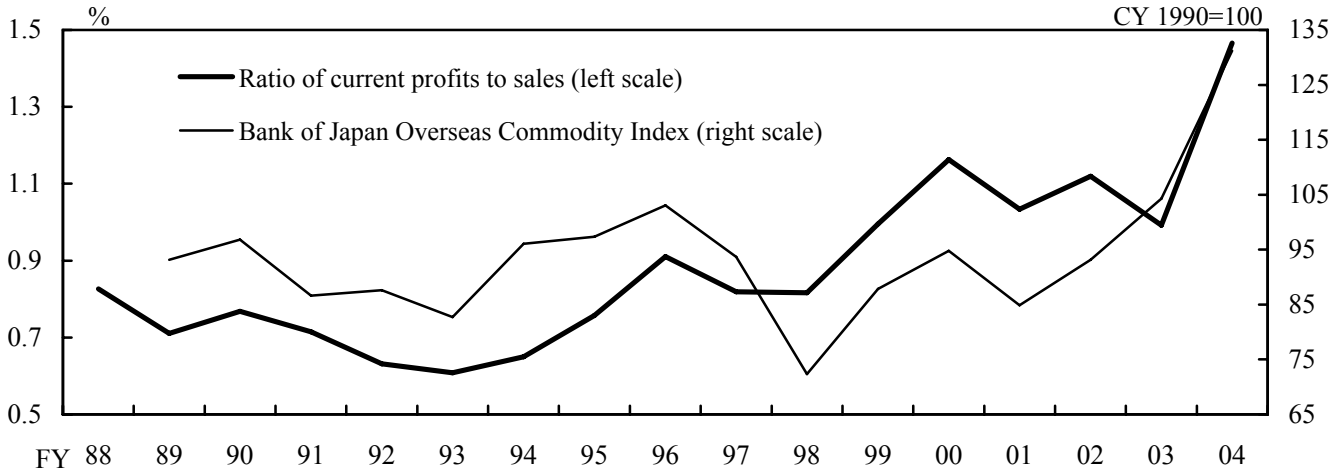
(1) Iron and Steel



(2) Chemicals



(3) Wholesale

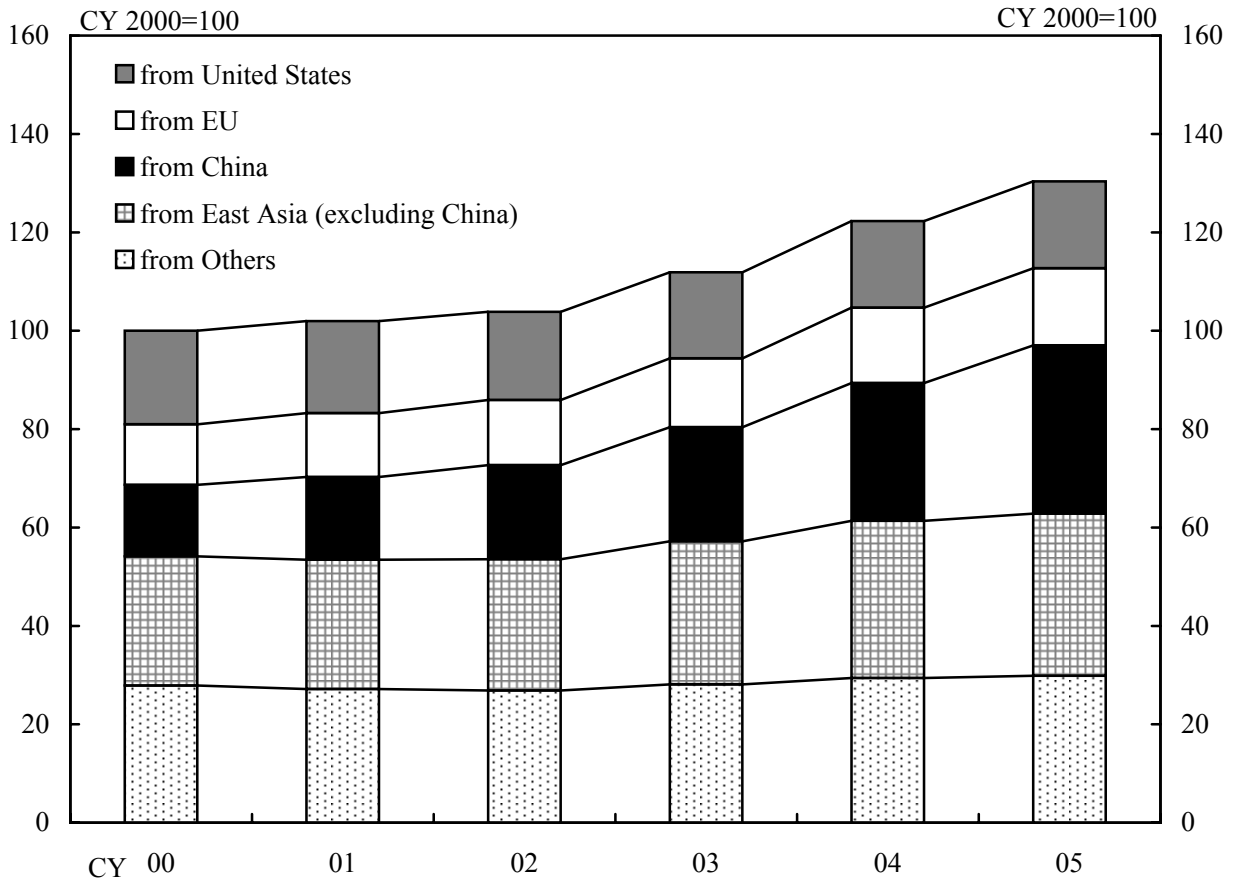


Note: Ratios of current profit to sales are those of large enterprises.

Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually";
Bank of Japan, "Corporate Goods Price Index," "Bank of Japan Overseas Commodity Index."

Chart 20

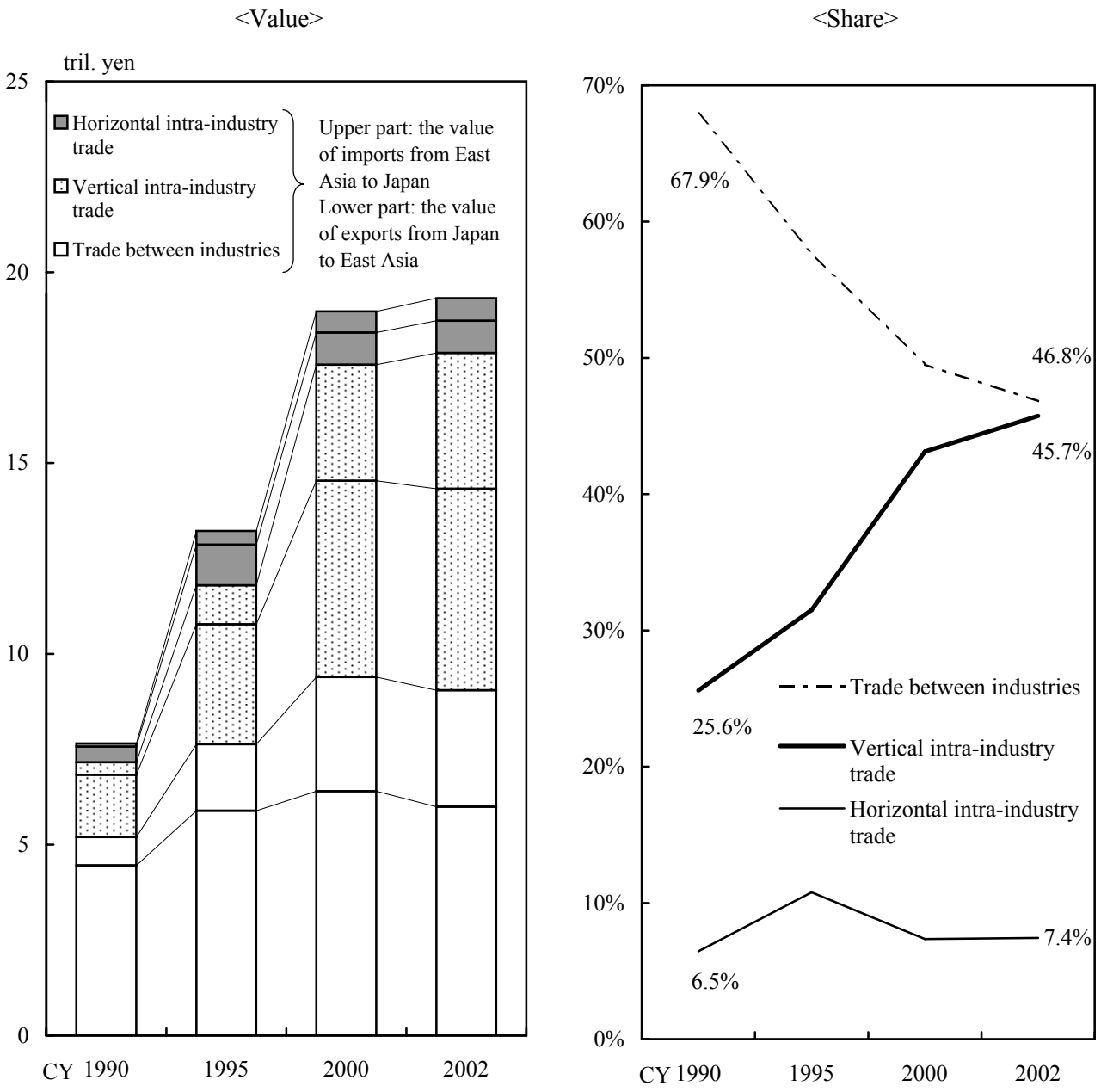
Real Imports



Notes: 1. Figures for CY 2005 are those of January-June in terms of annual amount.
2. Data for East Asia (excluding China) are those for NIEs and ASEAN4.

Sources: Ministry of Finance, "The Summary Report on Trade of Japan";
Bank of Japan, "Corporate Goods Price Index."

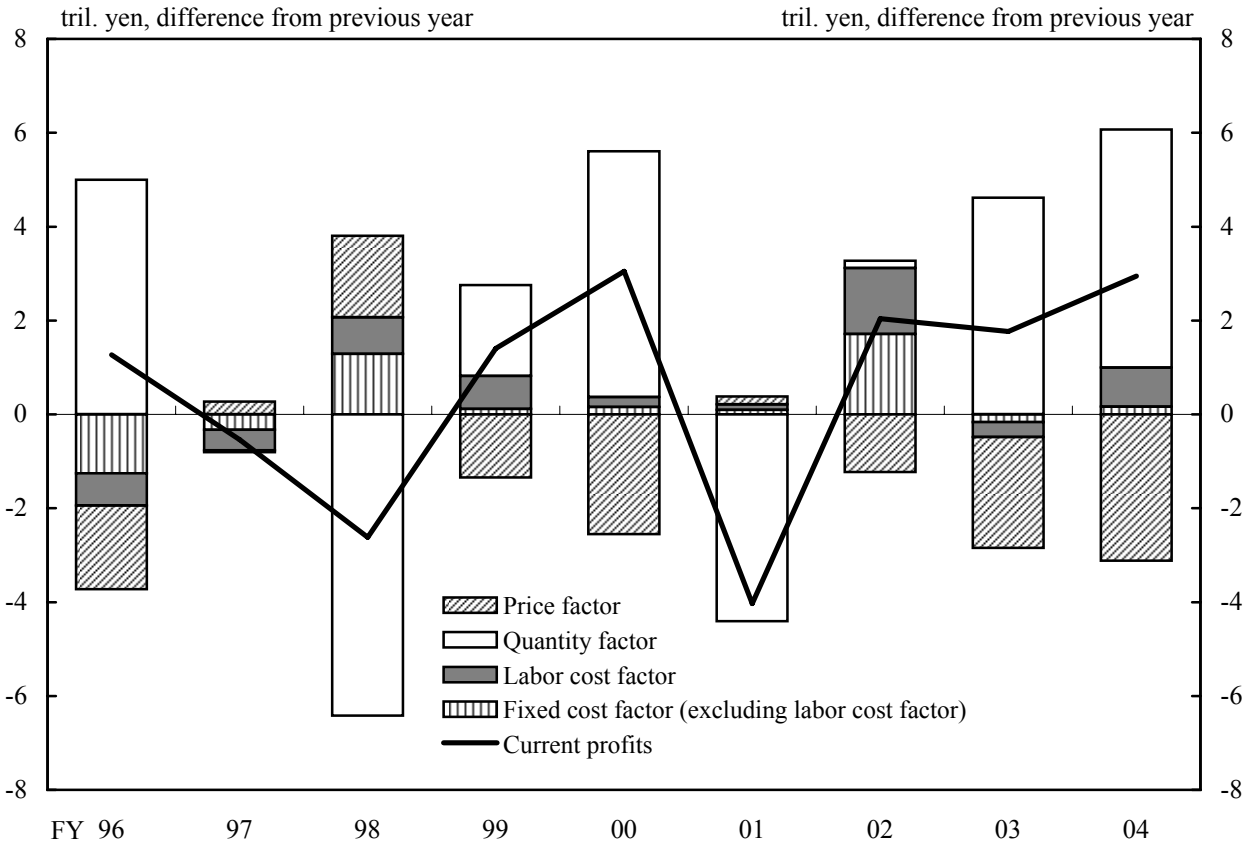
Division of Works between Japan and East Asia



Note: East Asia consists of China, NIEs and ASEAN4.

Source: Sasaki, H. and Koga, Y. "Trade Patterns in Japan's Machinary Sector", Bank of Japan Working Paper Series, No. 05-J-13, 2005 (in Japanese).

Factor Analysis of Current Profits at Large Manufacturing Enterprises



Notes : The factor analysis of current profits is based on the method below:

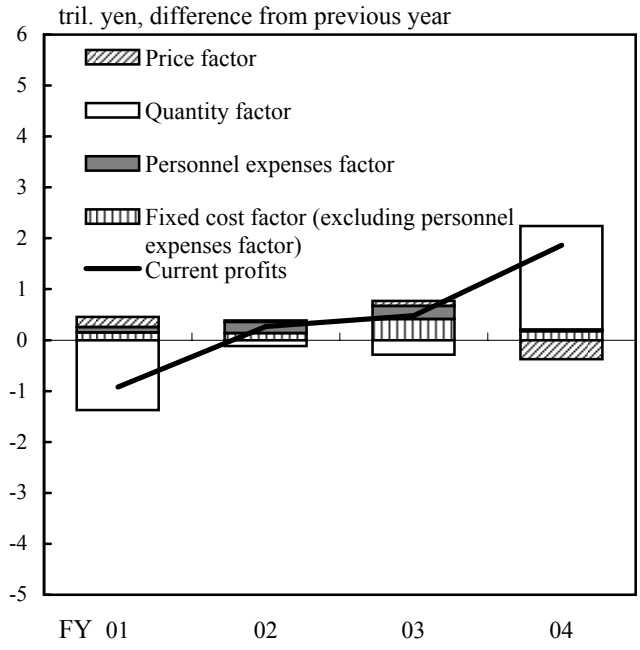
1. Current profits are divided into price factor, quantity factor, and other factors as follows:
   $\pi = P_O Q_O + P_I Q_I$ - FC - LC.
   (π: current profits, P_O: output price, Q_O: sales quantity, P_I: input price, Q_I: input quantity, FC: fixed costs (excluding personnel expenses), LC: personnel expenses).
2. Differences in π from its value in the previous year can be broken down into component differences attributable to changes in each of the right-hand-side variables above.
3. The variables above are calculated from *Financial Statements Statistics of Corporations by Industry, Annually* .
   π: current profits, $P_O Q_O$: sales, LC: personnel expenses, FC: the sum of depreciation and amortization expenses, net nonoperating expenses and selling and general administrative expenses × 0.7.
   (See note in Chart 5 for the definition of FC.)
4. "Price factor" refers to the difference attributed to changes in P_O, P_I calculated from *Input-Output Price Index of the Manufacturing Industry by Sector* .
5. "Quantity factor" refers to the difference attributed to changes in Q_O, Q_I. This factor is calculated as the total difference minus the sum of the differences attributed to other factors.

Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually";
Bank of Japan, "Input-Output Price Index of the Manufacturing Industry by Sector."

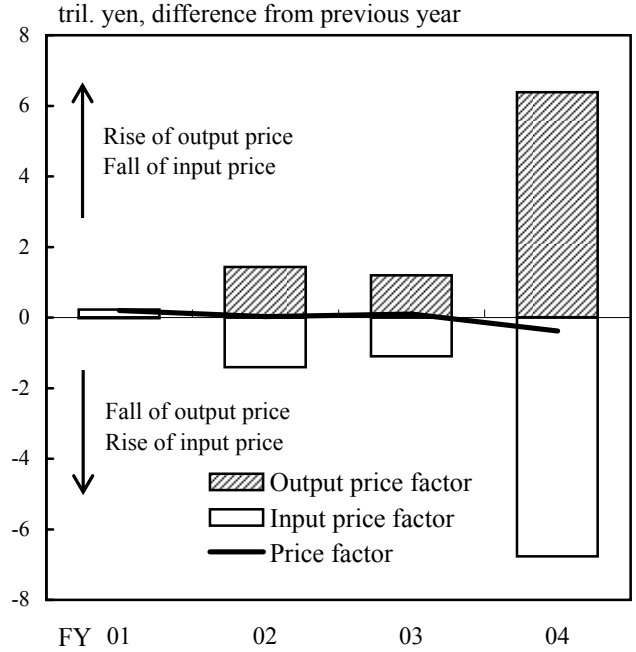
Materials and Processing Industries

(1) Materials industry (large enterprises)

a. Factor analysis of current profits

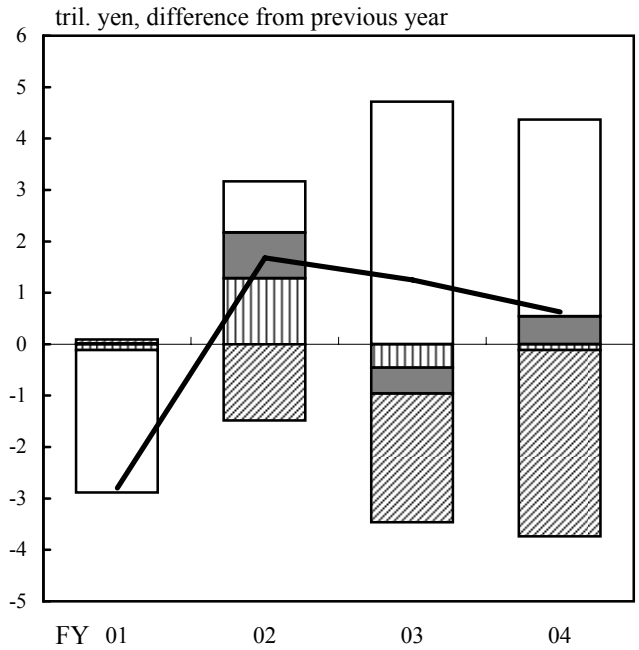


b. Factor analysis of price factor

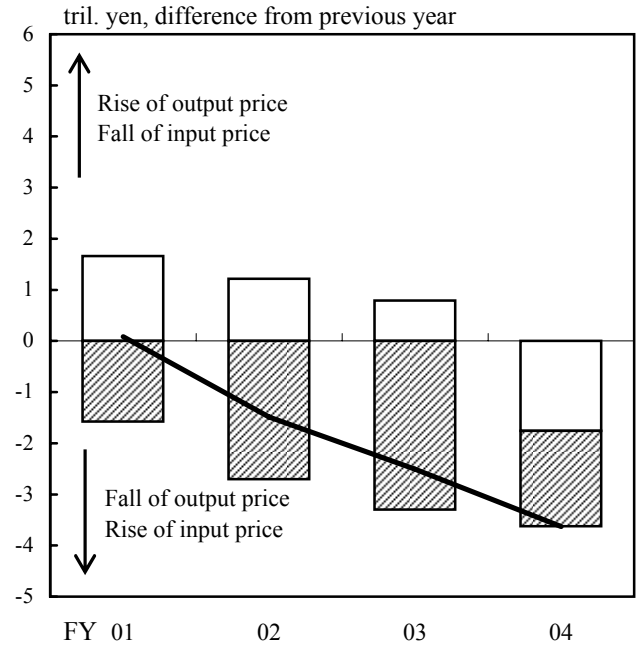


(2) Processing industry (large enterprises)

a. Factor analysis of current profits



b. Factor analysis of price factor

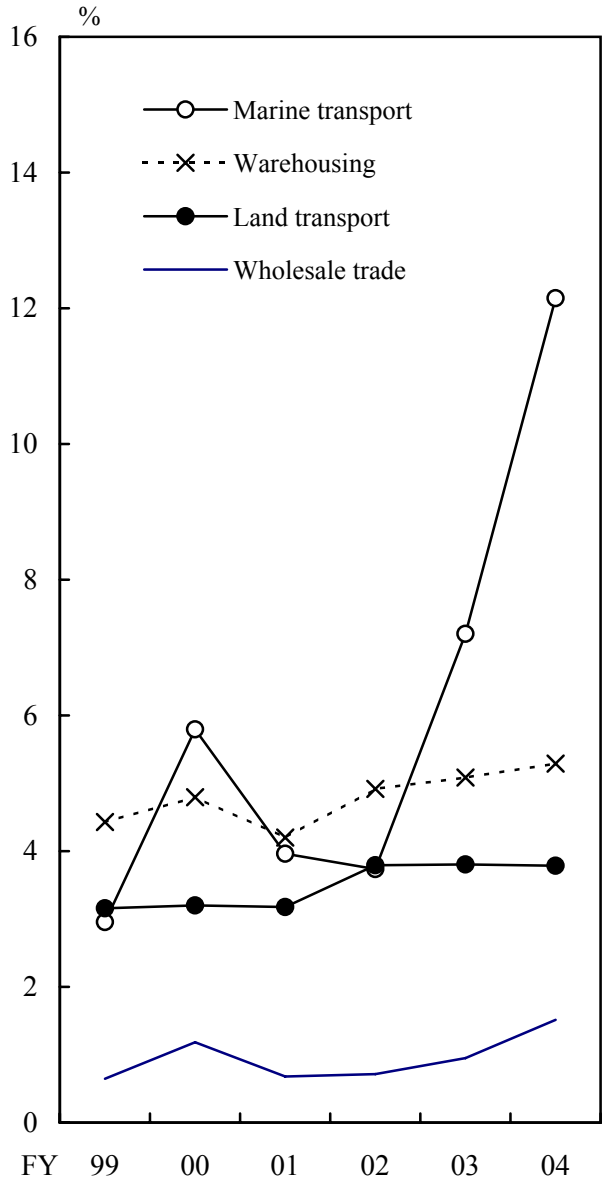


Notes: 1. See note in Chart 22 for calculation.
2. The materials industry consists of ceramics, stone and clay; nonferrous metals; iron and steel; petroleum and coal products; and chemicals. The processing industry consists of processed metals, general machinery, precision machinery, electrical machinery and transportation machinery. Total figures are not equal to those of Chart 22 because each industry consists of only 5 sectors.

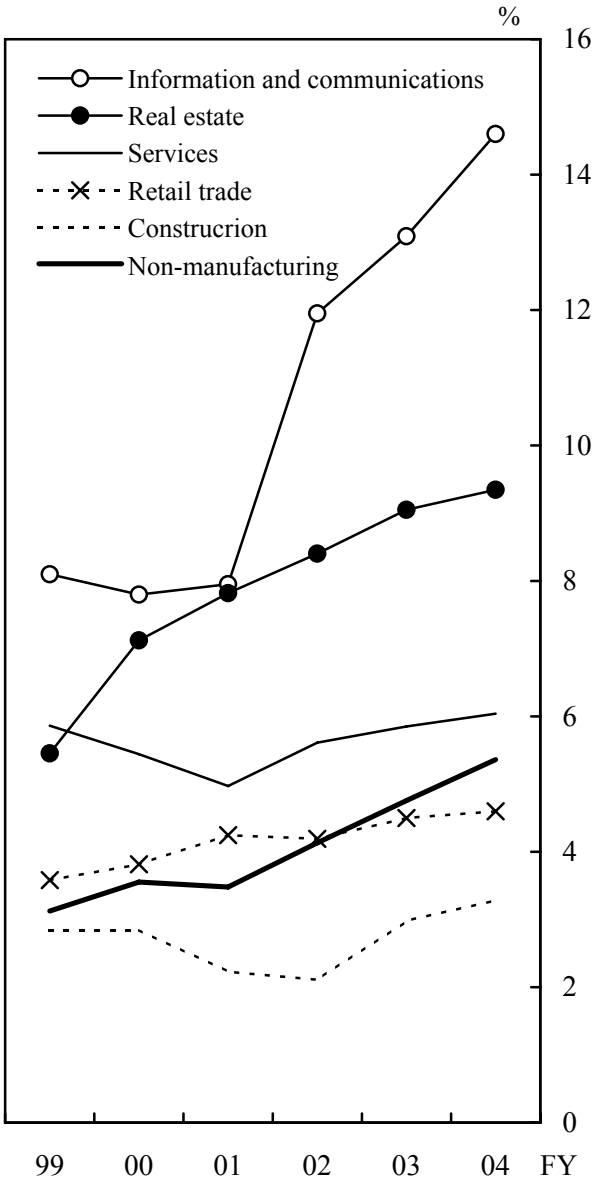
Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually";
Bank of Japan, "Input-Output Price Index of the Manufacturing Industry by Sector."

Ratios of Current Profits to Sales at Non-manufacturing Enterprises

(1) Industries related to goods



(2) Other industries



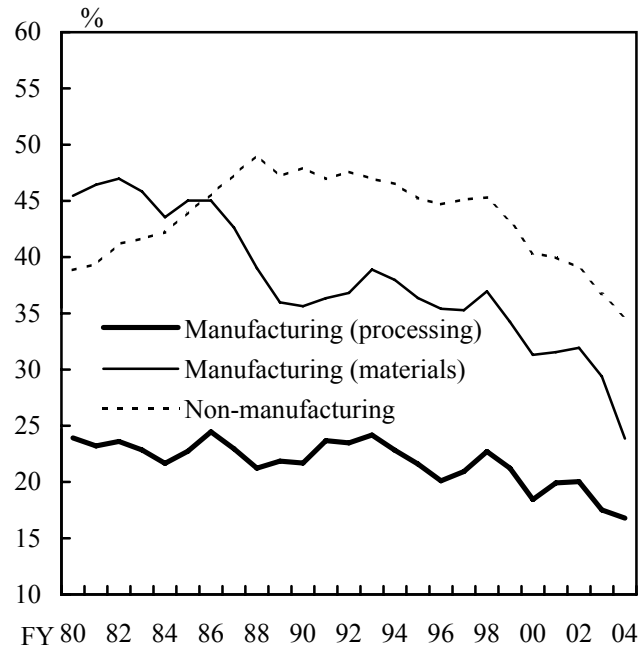
Note: Figures are based on the 1,476 enterprises whose data have been available on a continuous basis since FY 1999.

Source: Nikkei Financial QUEST.

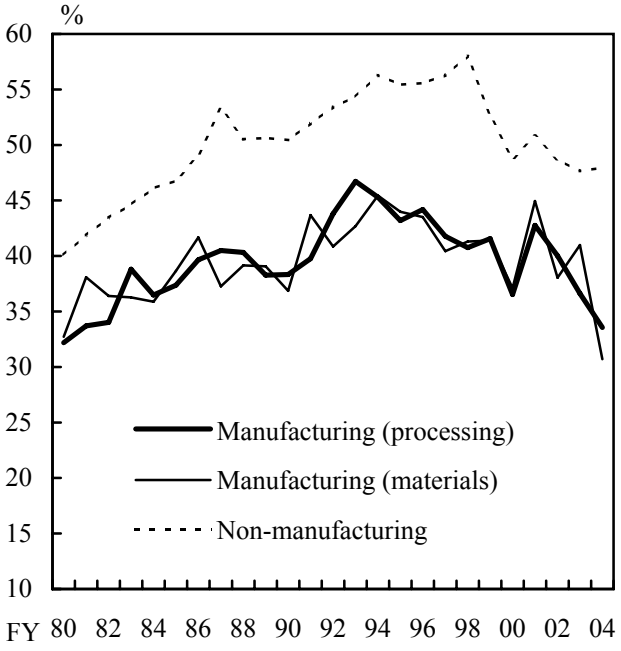
Progress of Balance Sheet Adjustment

(1) Interest-bearing debt / total assets

a. Large enterprises

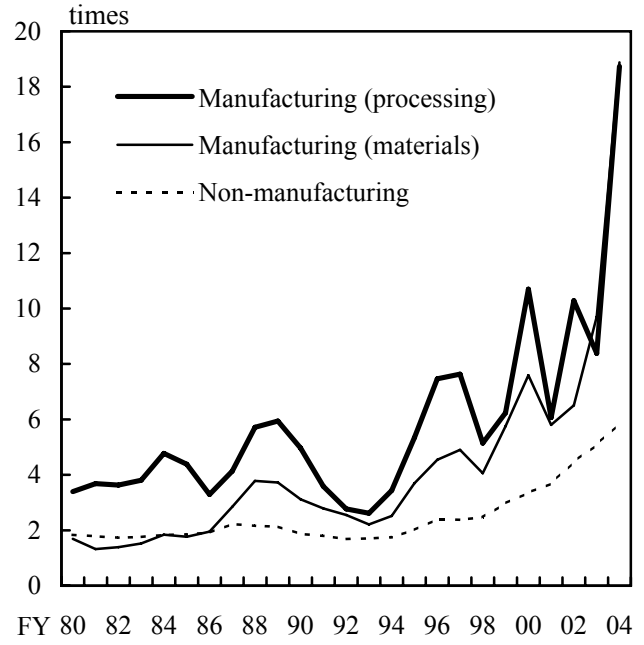


b. Medium-sized and small enterprises

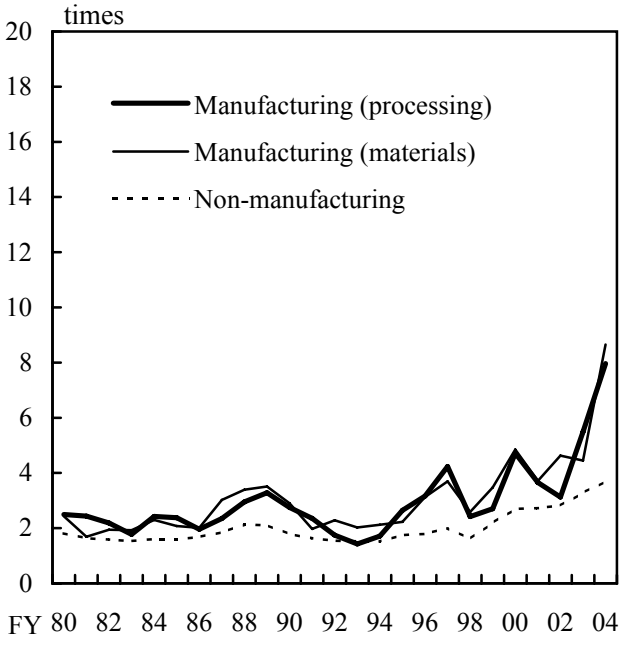


(2) Interest coverage ratio

a. Large enterprises



b. Medium-sized and small enterprises

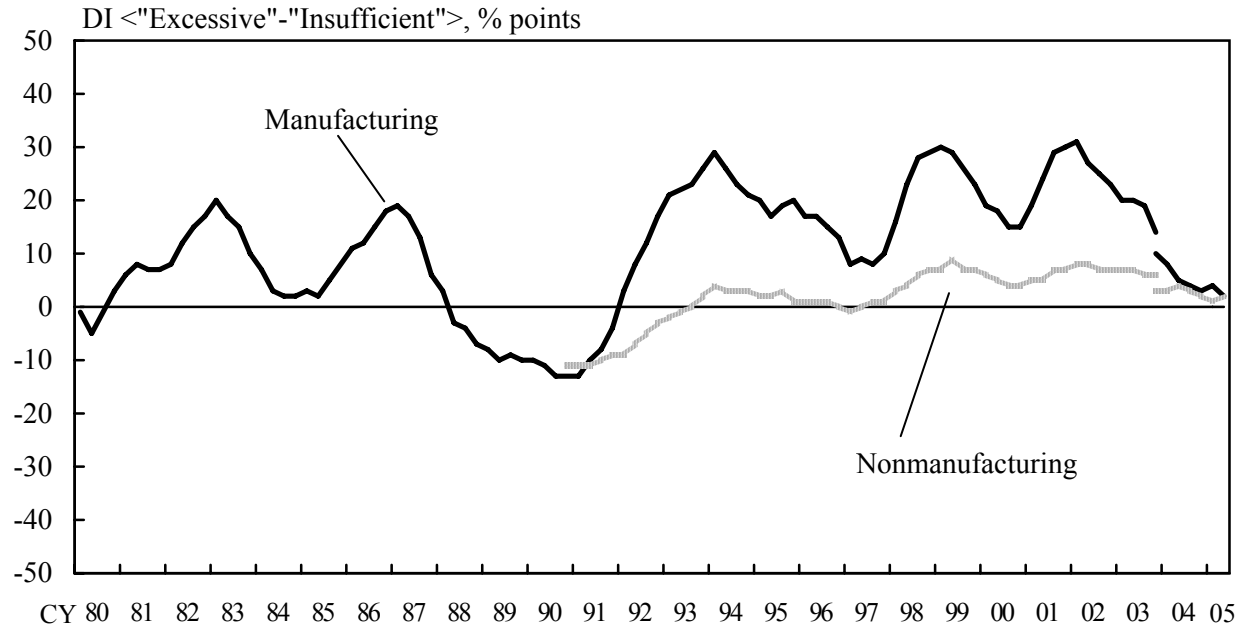


Notes: 1. Data are for all industries excluding electric and gas utilities.
2. Interest-bearing debt = long-term and short-term loans + corporate bonds.
3. Interest coverage ratio = (current profits + interest expense) / interest expense.

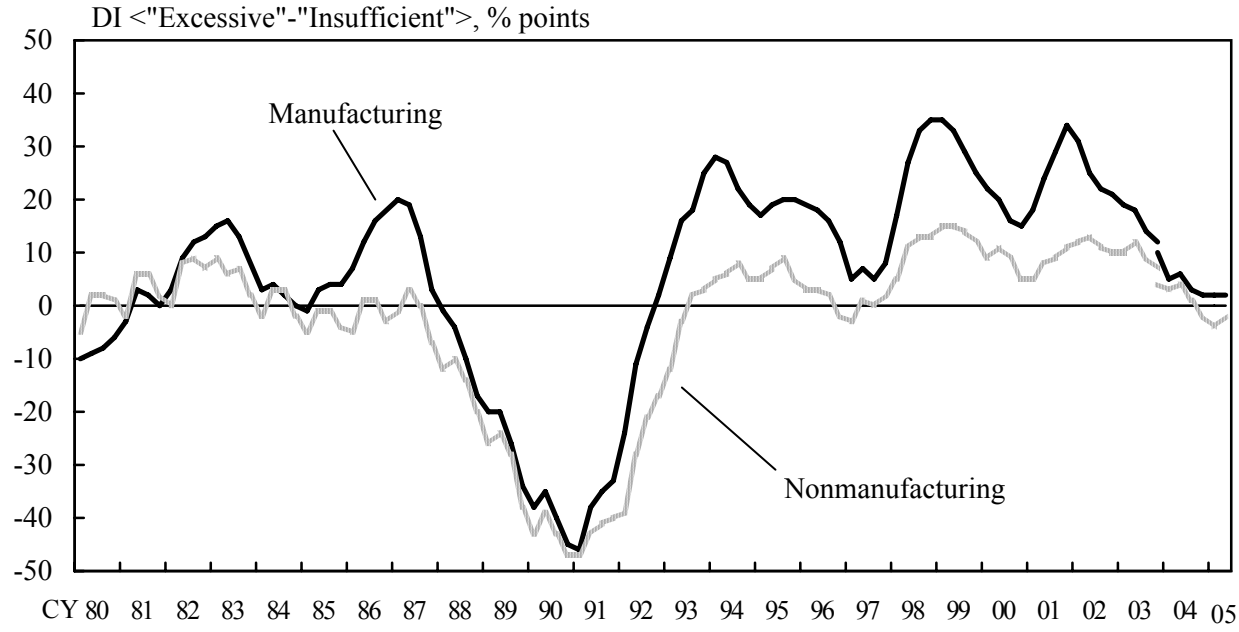
Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually."

Excess Production Capacity and Employment

(1) Excess production capacity



(2) Excess employment



Notes: 1. Data are for all scale enterprises.
2. There is no continuity between the figures up to the December 2003 survey and those from the March 2004 survey (as for the December 2003 survey, the results of preliminary survey based on "Capital" are also shown).

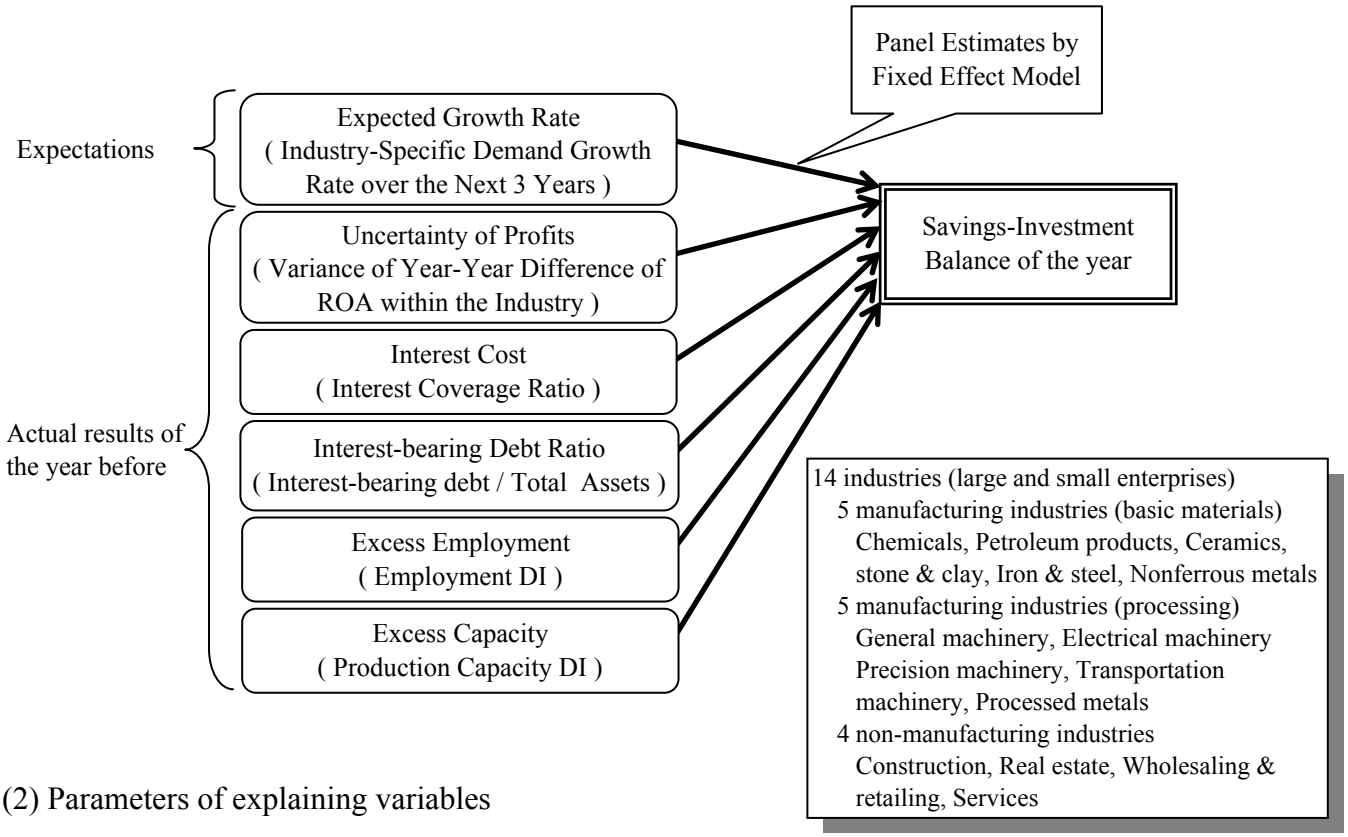
Source: Bank of Japan, "*Tankan,* Short-term Economic Survey of Enterprises in Japan."

Three Excesses and Business Investment

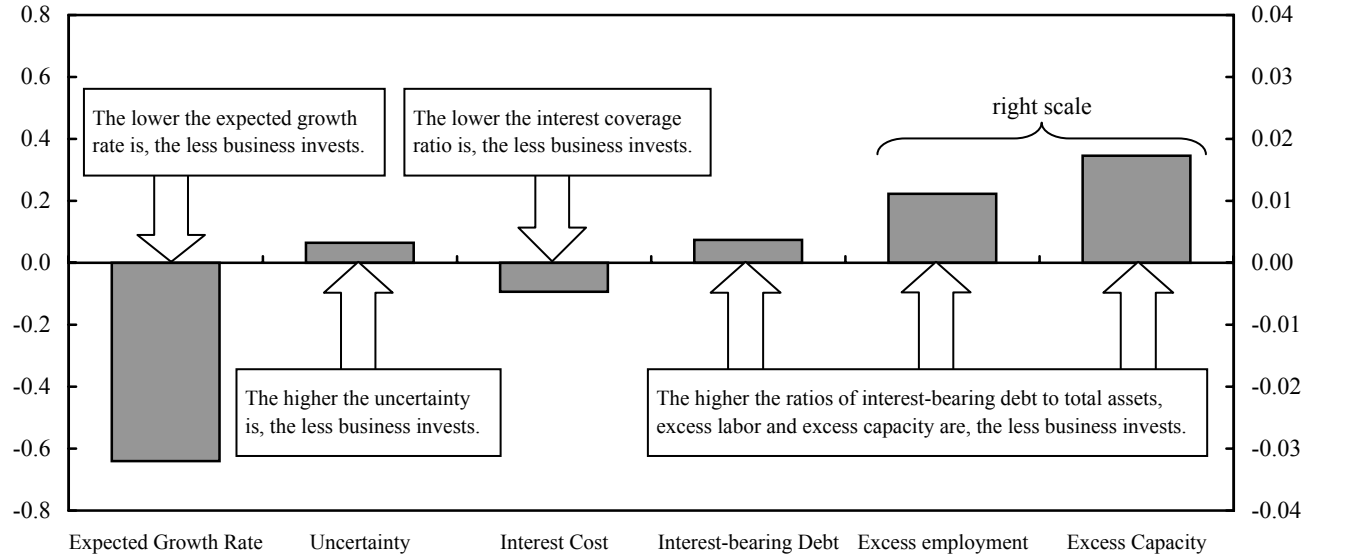
(1) Overview of estimate

Panel estimates of savings-investment balance of corporate sector

Expected growth rate, uncertainty, three excesses (excess debt, excess employment and excess capacity) and time dummy variable are used as the explaining variables. Sample period is from FY 1982 to FY 2003.



(2) Parameters of explaining variables

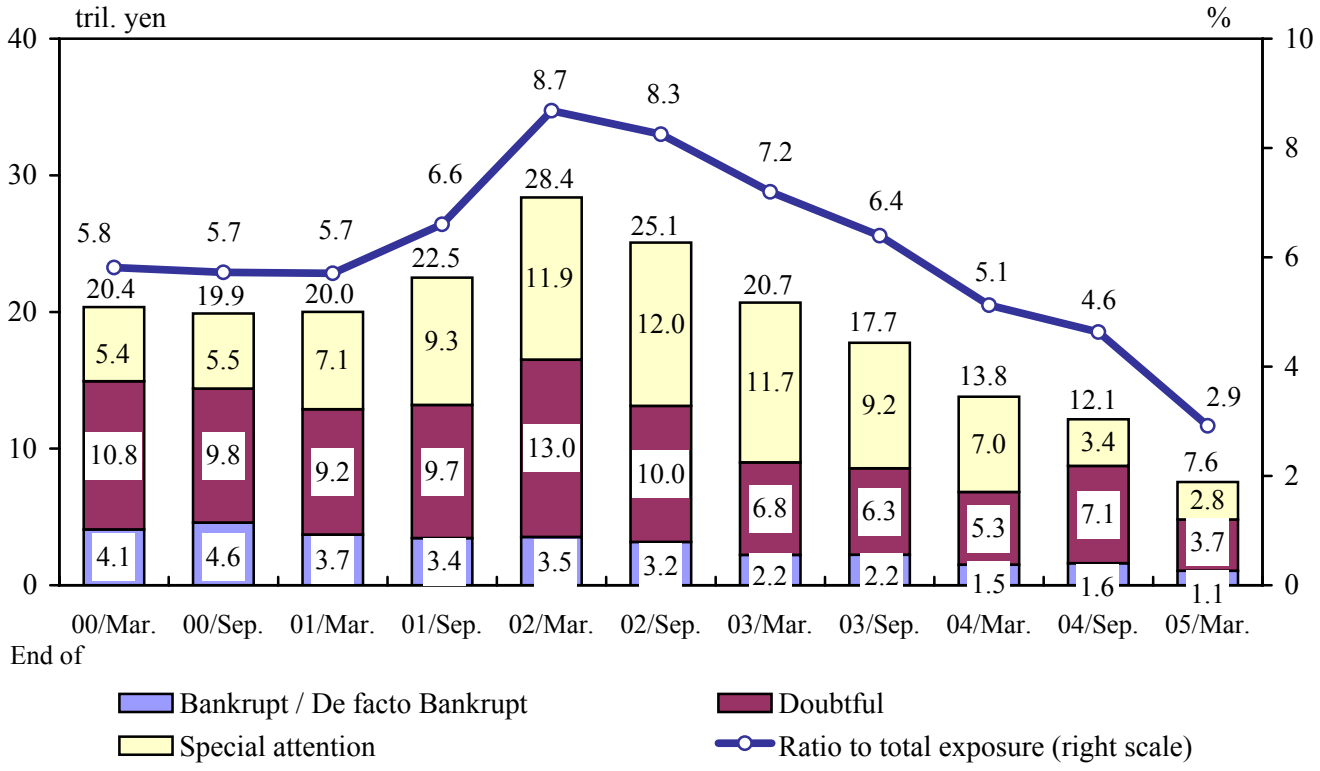


Note: Interest coverage ratio is significant at the 10% level, while the others are significant at the 5% level.

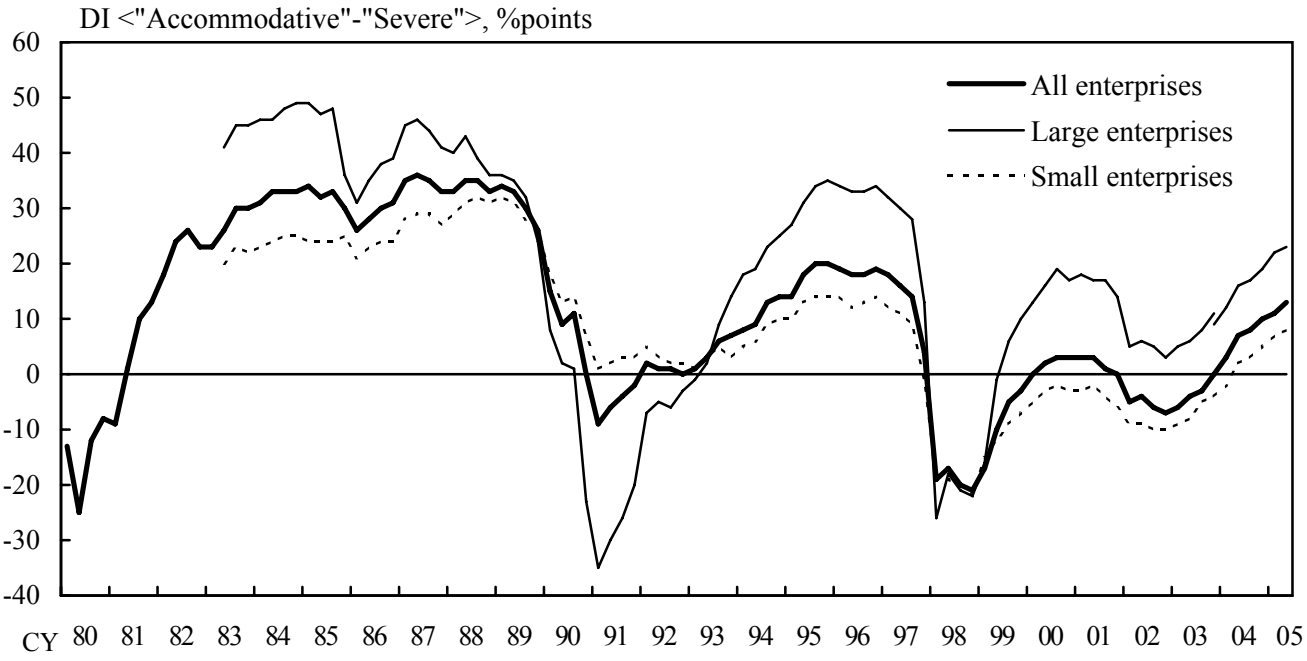
Sources: Ministry of Finance, "Financial Statement Statistics of Corporations by Industry, Annually"; Cabinet Office, "Annual Survey of Corporate Behavior"; Development Bank of Japan, "Corporate Financial Data Bank"; Bank of Japan, "*Tankan,* Short-term Economic Survey of Enterprises in Japan."

Stabilization of the Financial System

(1) Non-performing loans of major banks



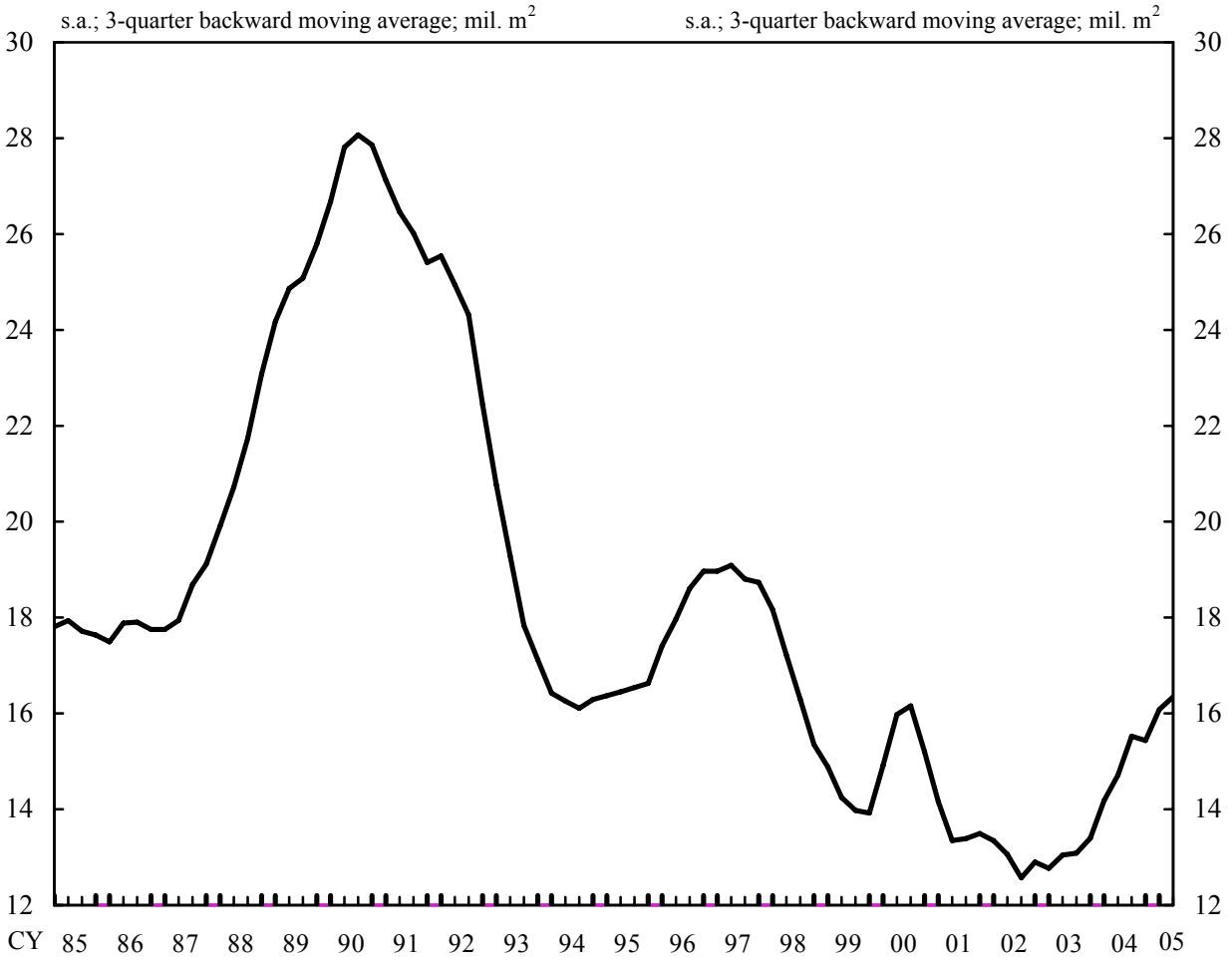
(2) Lending attitude of financial institutions (all industries)



Note: See note in Chart 26, for discontinuity of the data at the end of CY 2003.

Sources: Financial Services Agency, "Status of Non-Performing Loans;
Bank of Japan, "*Tankan,* Short-term Economic Survey of Enterprises in Japan."

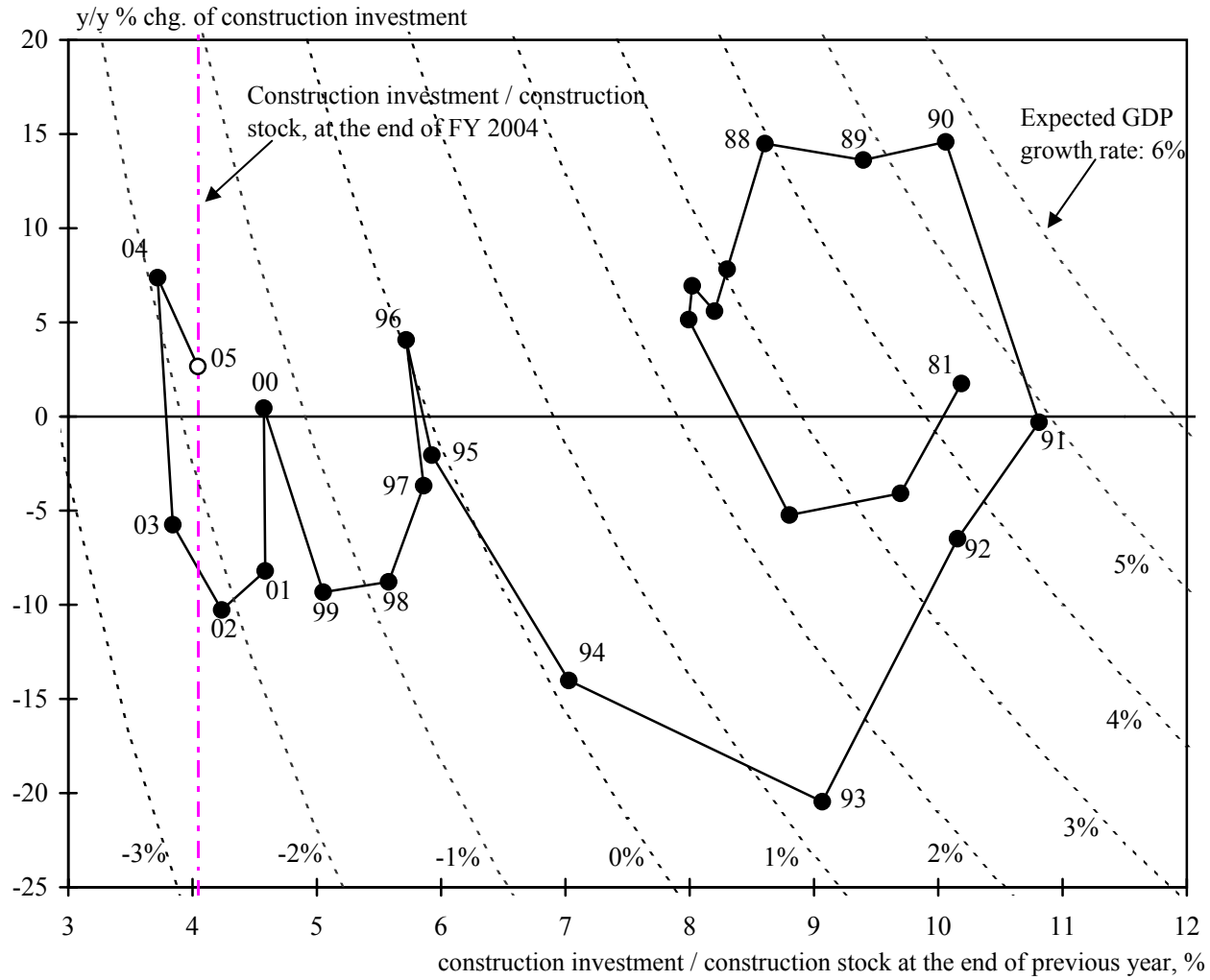
Construction Starts



Notes: 1. Seasonally adjusted by X-12-ARIMA.
2. Because the Standard Industrial Classification for Japan was revised in March 2002, the industry classification for Newspaper Publishing and Publishing Business was changed from Mining and Manufacturing to Nonmanufacturing. Accordingly, the data up to FY 2002 were adjusted by using a link coefficient.

Source: Ministry of Land, Infrastructure and Transport, "Statistics on Building Construction Starts."

Construction Stock Cycle



Notes: 1. On the assumption that there is a certain relation between economic growth and capital stock,

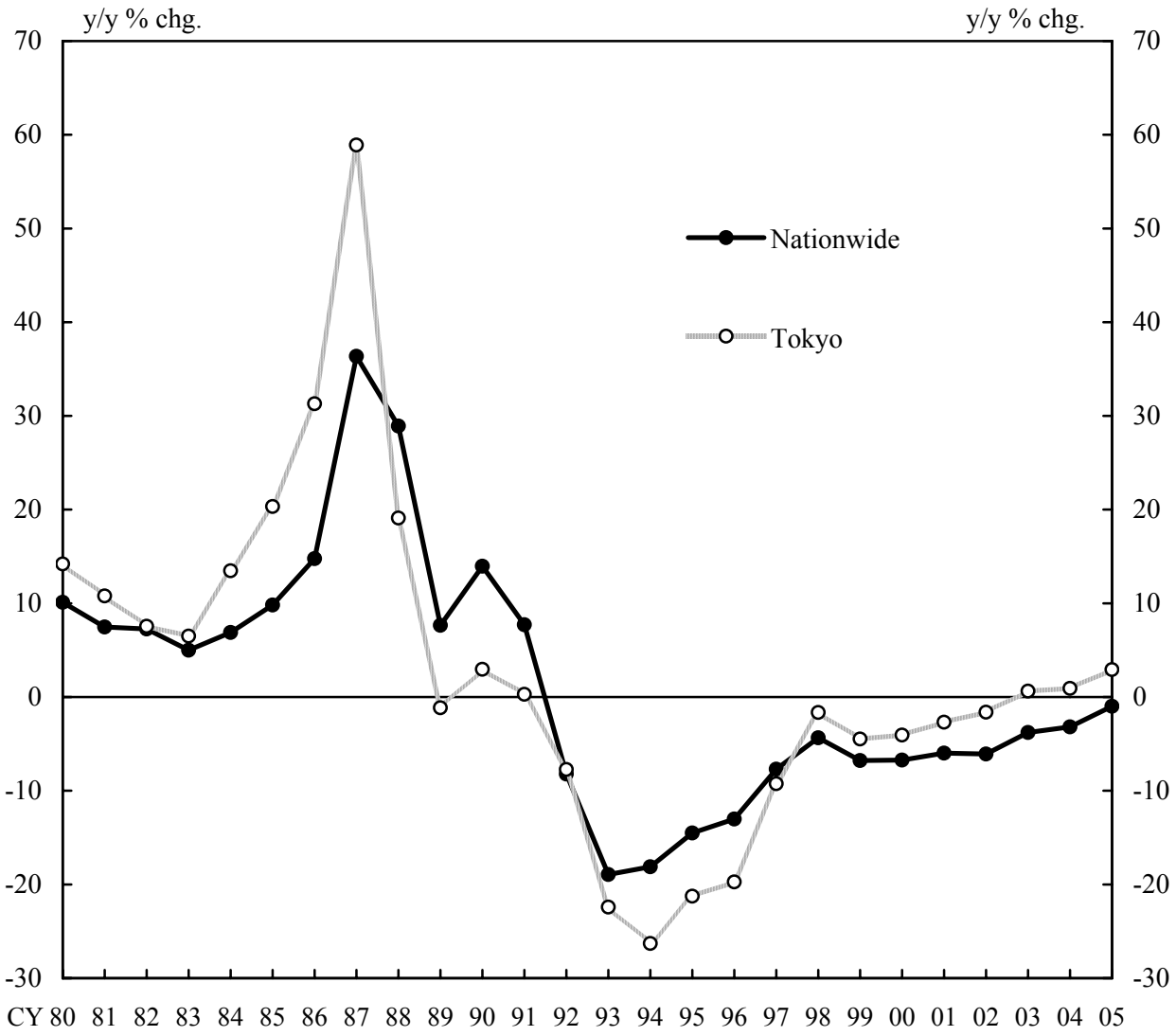
y/y % chg. of construction investment of the year
= (scrapping ratio + trend of the capital coefficient + expected growth rate)
/ ratio of construction investment to construction stock at the end of previous year

In the formula, if the scrapping ratio and the trend of the capital coefficient (= capital stock / real GDP) are assigned the previous average values, y/y % chg. of construction investment of the year (y-axis position) is determined as the intersection of the ratio of construction investment to construction stock at the end of the previous year (x-axis position) with the expected growth rate (dotted contours). See BOX 2 of *Recent Trends in Business Fixed Investment and the Issues Attending a Full Recovery: Restoring Firms' Capacity to Generate Capital Investment (BOJ Research and Statistics Department, Bank of Japan Research Papers, Sep. 2003* for further explanation.

2. Estimated construction investment for FY 2005 is forecast by Ministry of Land, Infrastructure and Transport.

Sources: Ministry of Land, Infrastructure and Transport, "Estimate of Construction Investment";
Cabinet Office, "Gross Capital Stock of Private Enterprises", etc.

Land prices

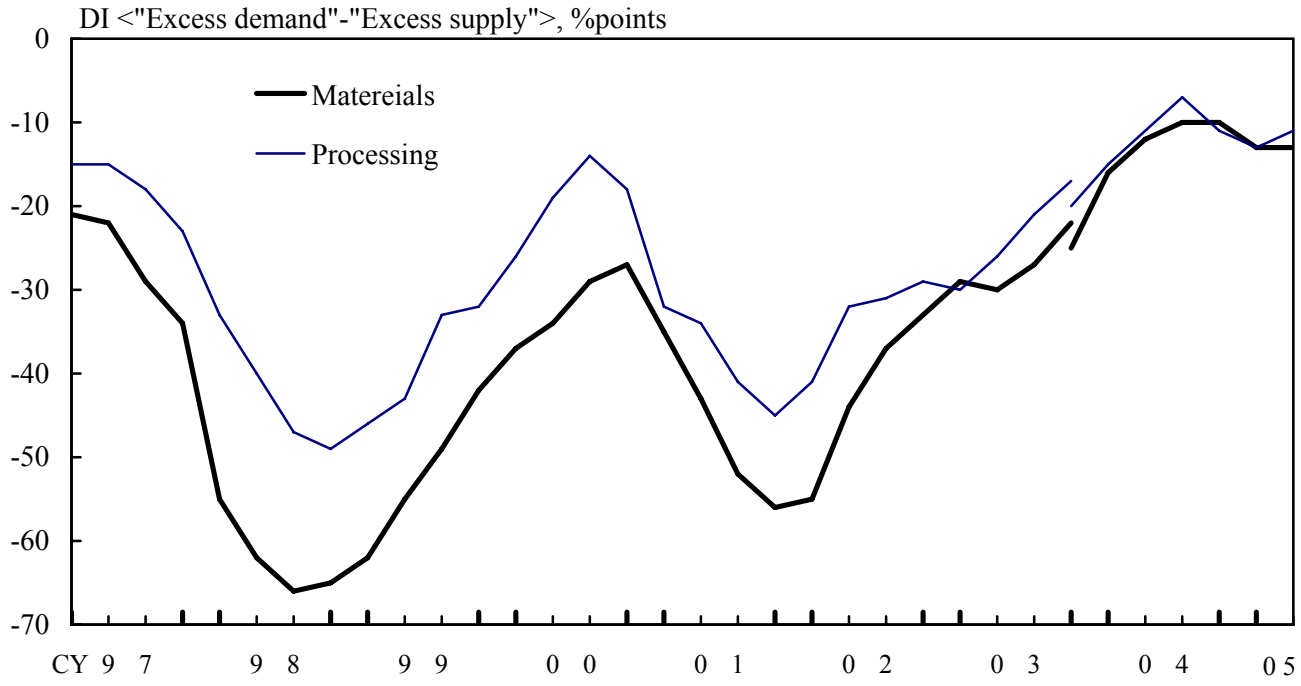


Note: The data here are calculated as the *weighted* average of changes in unit prices, and thus differ from the official land price data which are based on the *simple* average.

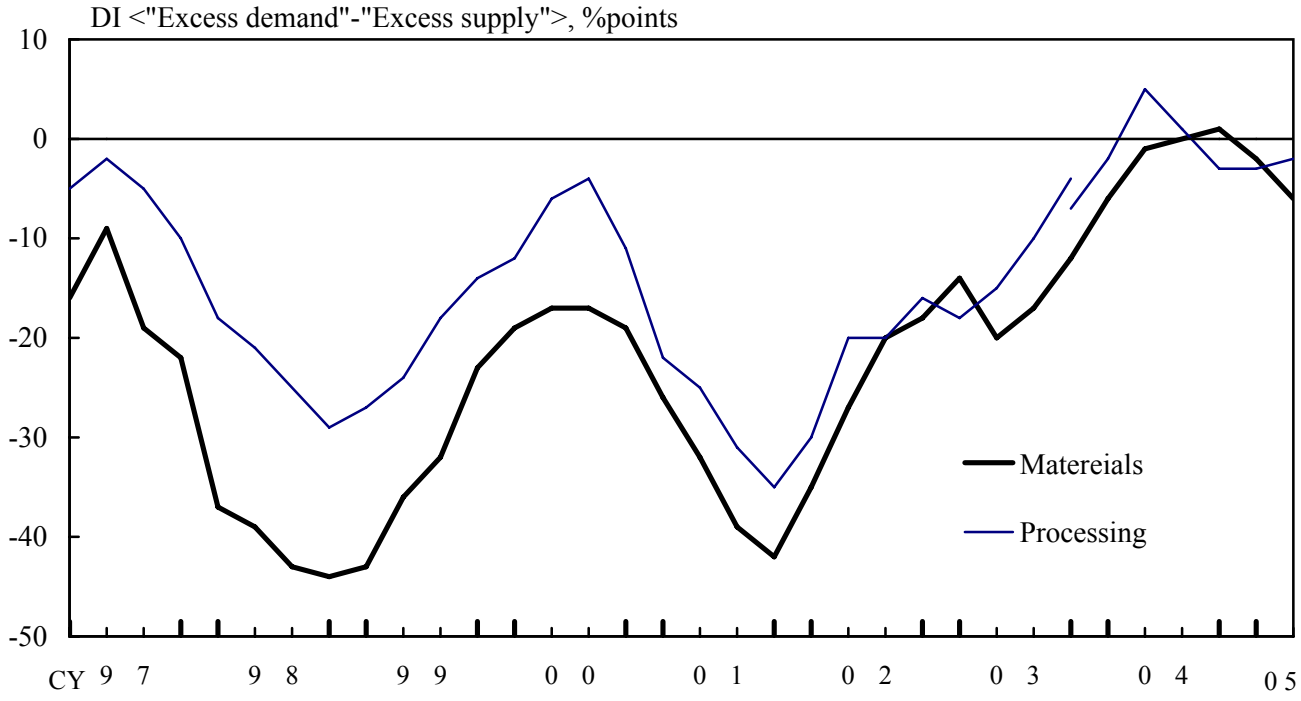
Source: Ministry of Land, Infrastructure and Transport, "Publication of Land Price."

Supply and Demand Conditions DI (Large Enterprises)

(1) Domestic



(2) Overseas

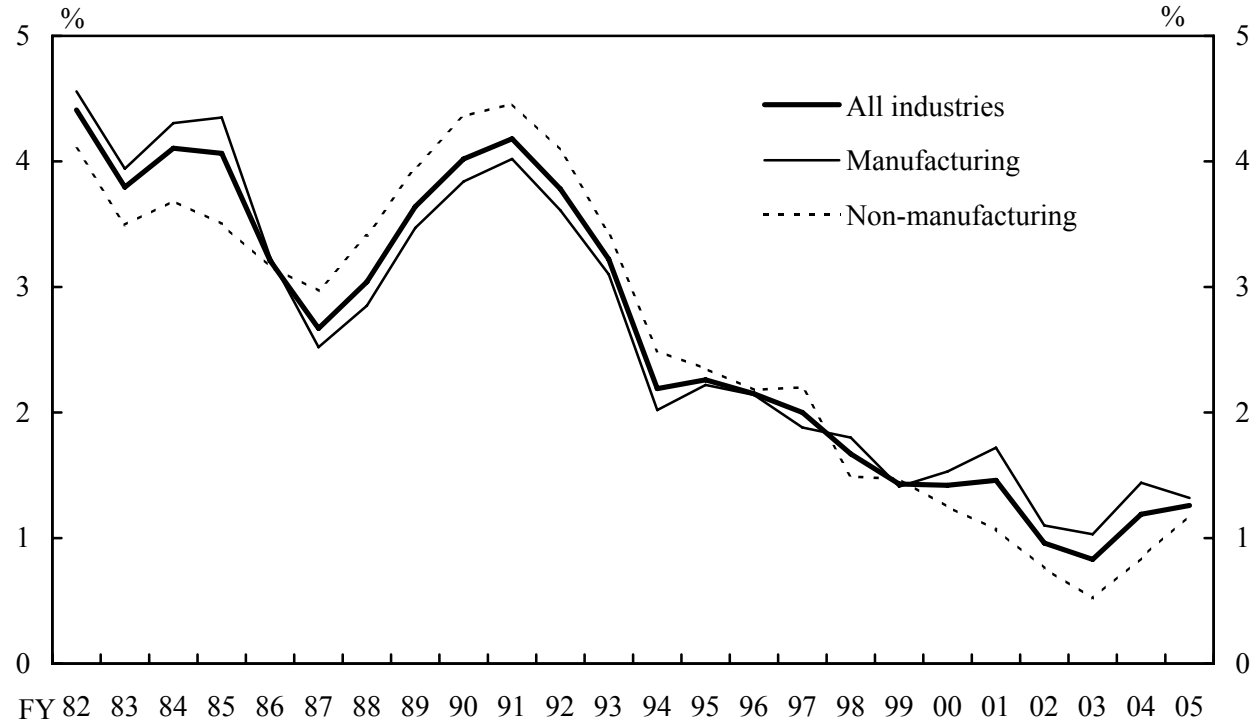


Notes: 1. Large enterprises (pre-revision): 1,000 employees or more
Large enterprises (post-revision): capital with 1 billion yen and more
2. See note in Chart 26, for discontinuity of the data in CY 2003.

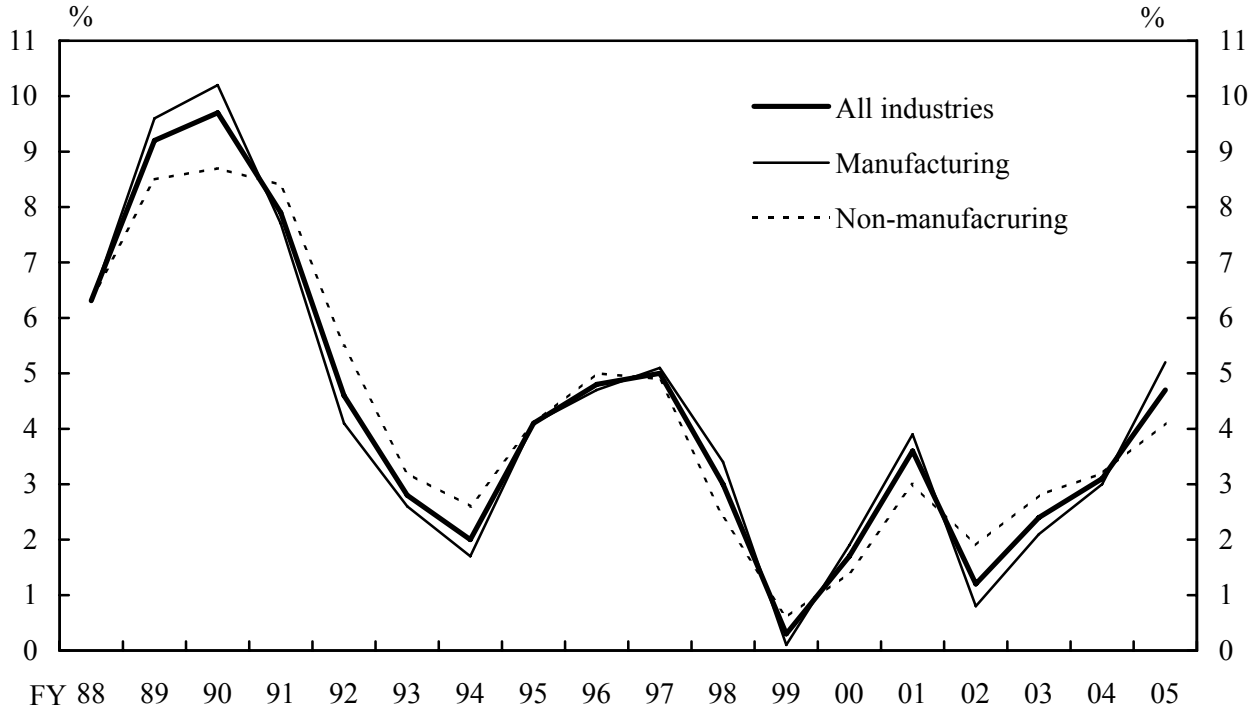
Source: Bank of Japan, "*Tankan,* Short-term Economic Survey of Enterprises in Japan."

Expected Demand Growth Rate and Capital Investments

(1) Expected industry-specific real demand growth rate over the next 5 years (annual average)

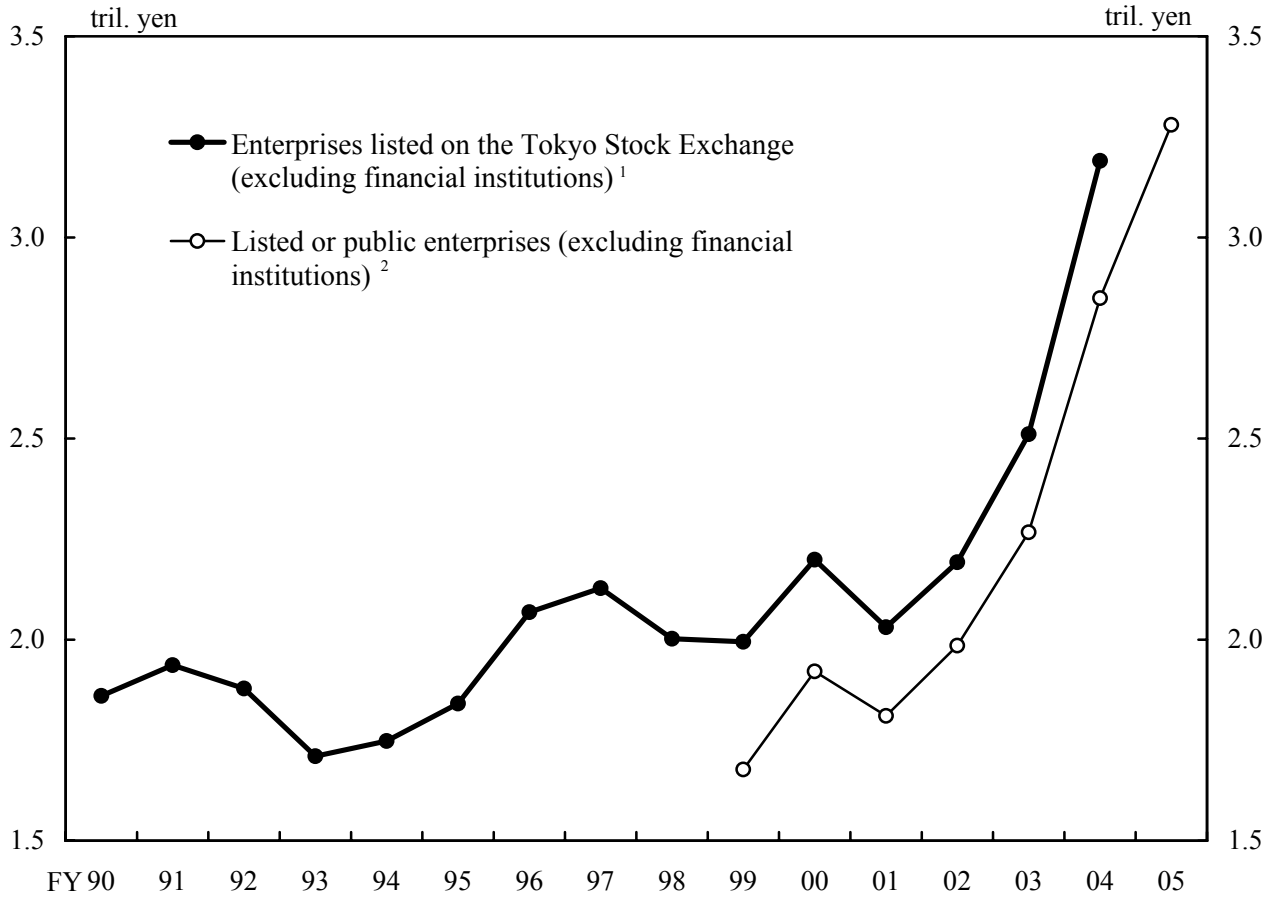


(2) Expected capital investments over the next 3 years (annual average)



Source: Cabinet Office, "Annual Survey of Corporate Behavior."

Dividend Payments

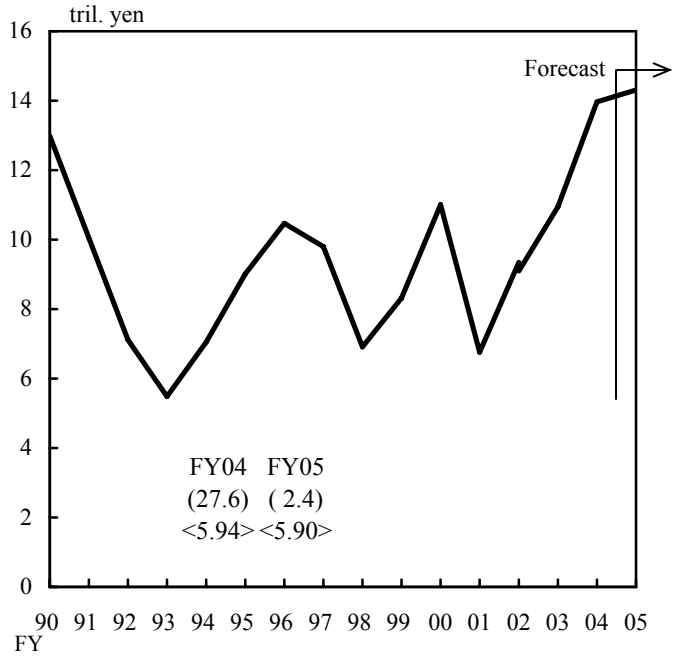


Notes: 1. Figures are total of dividends paid by enterprises whose fiscal year ends in March.
2. Figures are for 345 listed enterprises on a consolidated basis (including 217 manufacturing and 128 nonmanufacturing enterprises). For FY 2004 (either actual results or forecasts) and FY 2005 (forecasts), figures are based on information available as of June, 2005. Where forecasts made by each enterprise are not available, forecasts by TOYO KEIZAI are used.

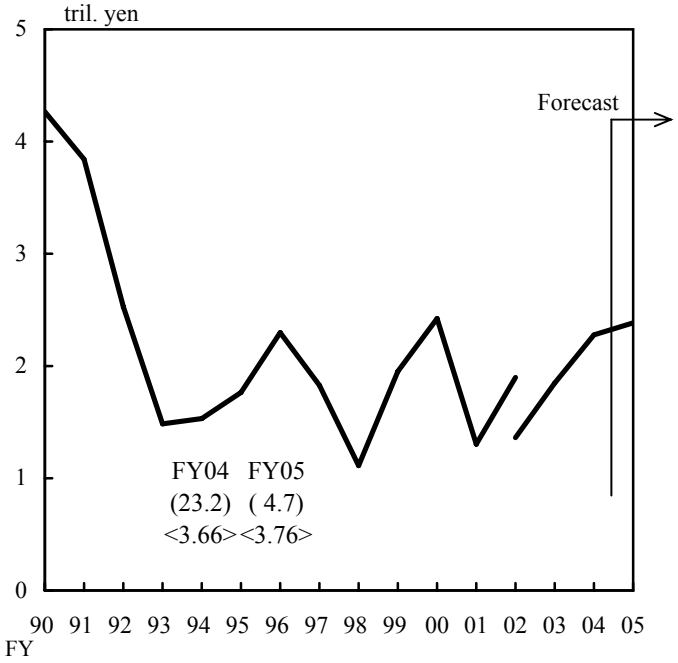
Sources : Tokyo Stock Exchange; Nomura Securities Co., Ltd.

Current Profits

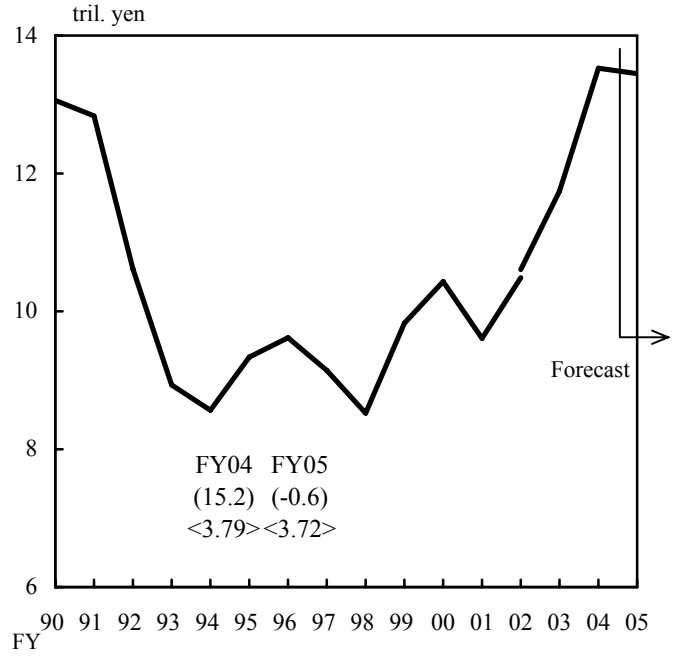
(1) Manufacturing Large Enterprises



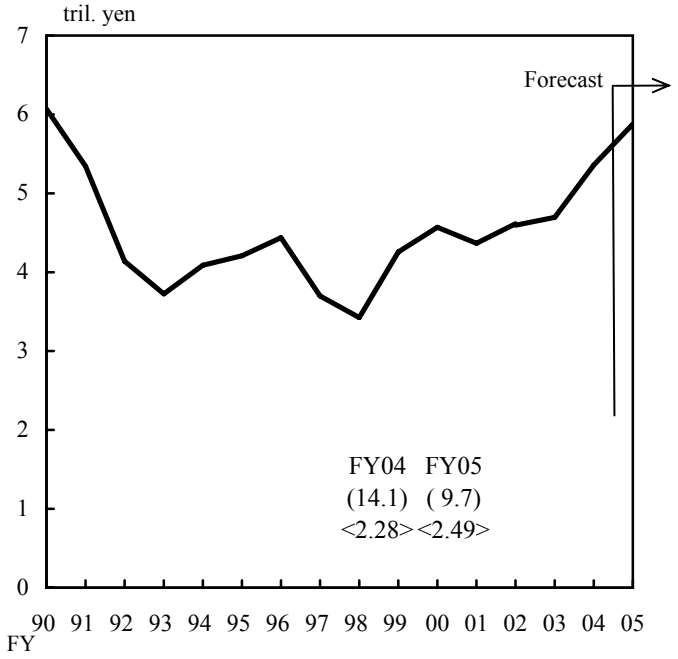
(2) Manufacturing Small Enterprises



(3) Nonmanufacturing Large Enterprises



(4) Nonmanufacturing Small Enterprises

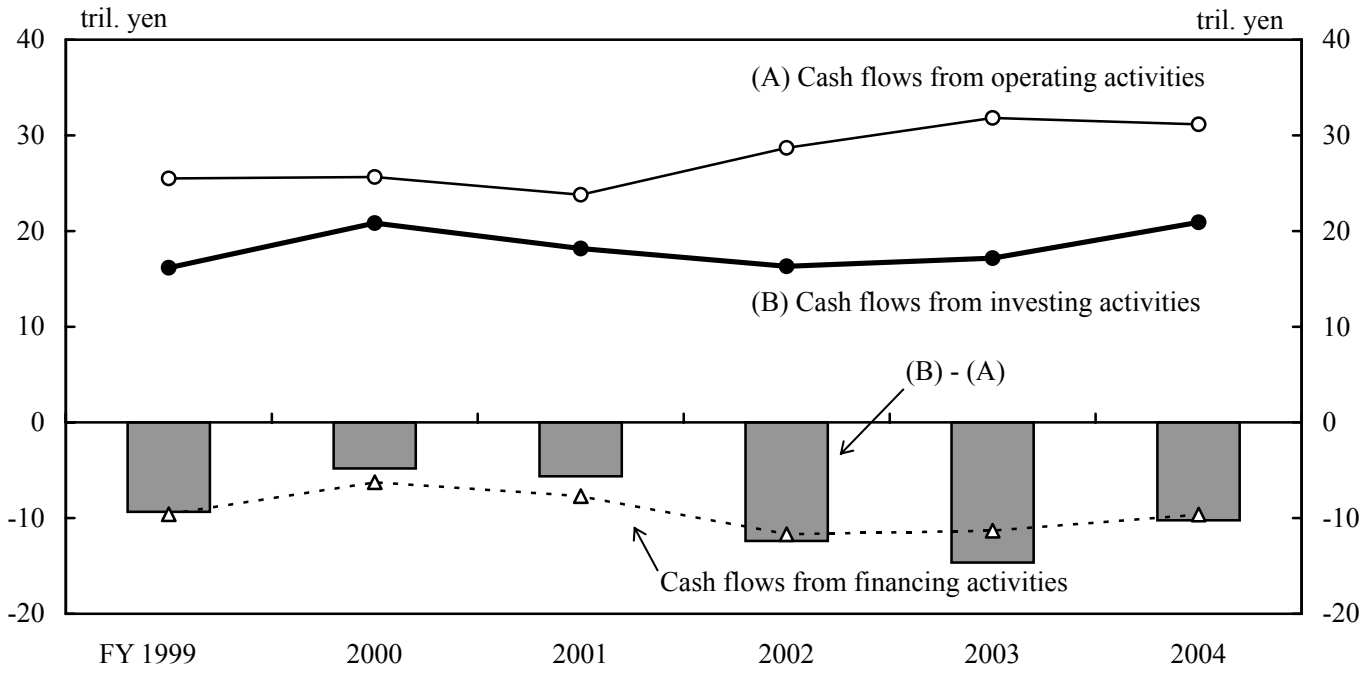


Notes: 1. Large enterprises (pre-revision): 1,000 employees or more
Small enterprises (pre-revision): 50-299 employees (for Manufacturing), 20-99 employees (for Wholesaling), 20-49 employees (for Retailing, services, and leasing), 50-299 employees (for Other industries)
Large enterprises (post-revision): capital with 1 billion yen and more
Small enterprises (post-revision): capital with 20 million yen to less than 100 million yen
2. ( ): Current Profits (y/y% chg.), < >: Ratio of current profits to sales (%).
3. See note in Chart 26 for discontinuity of the data in FY 2002.

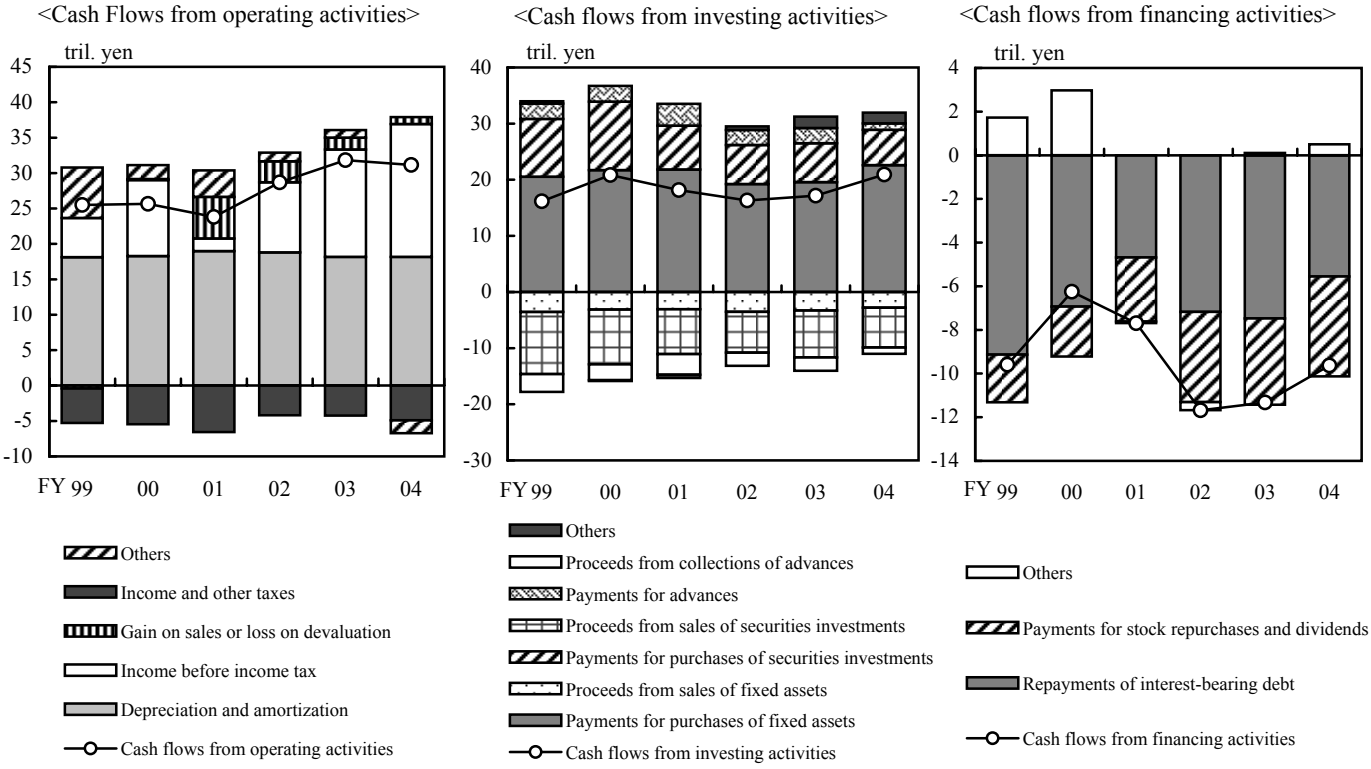
Source: Bank of Japan, "*Tankan*, Short-term Economic Survey of Enterprises in Japan."

Cash Flows of Business Enterprises

(1) Overview of cash flows



(2) Content of cash flows

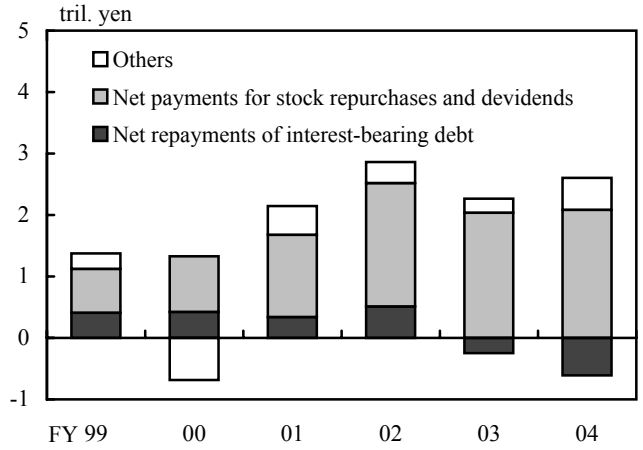


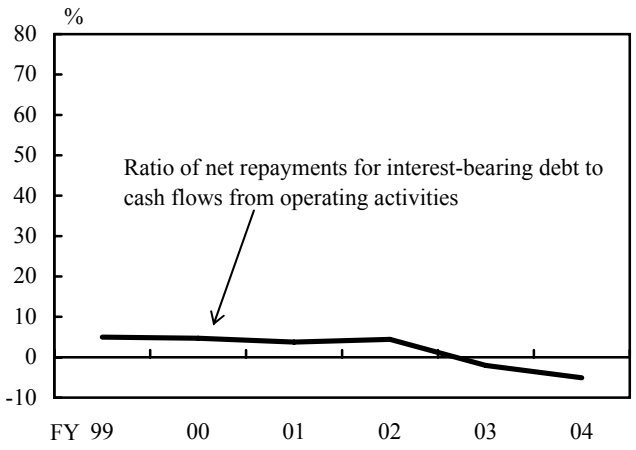
Note: Data are for 1,072 enterprises (excluding financial, electric and gas enterprises) listed on the Tokyo Stock Exchange First section which have continuously disclosed consolidated statements of cash flows since FY 1999.

Source: Nikkei Financial QUEST.

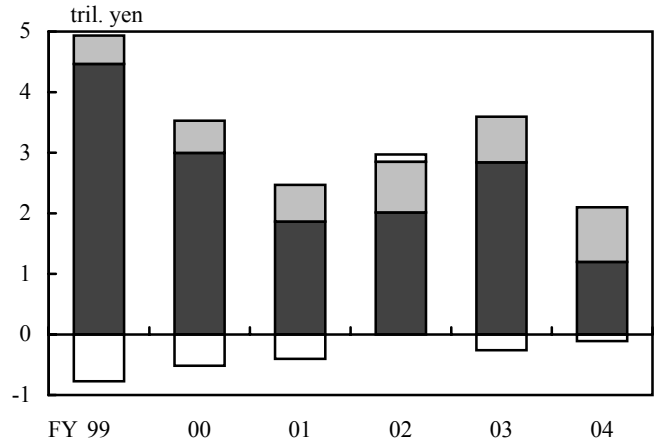
Comparison of Cash Flows by Ratings

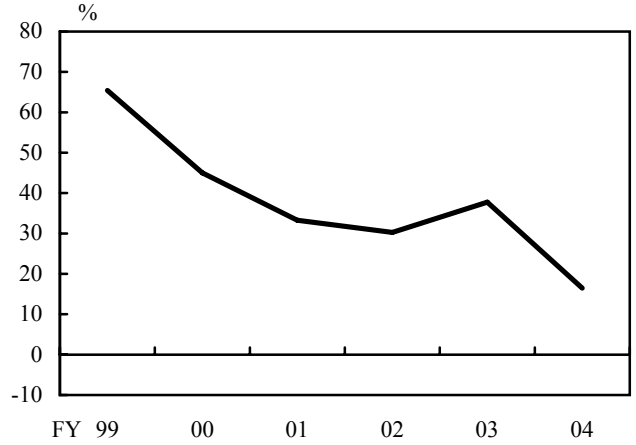
(1) Rating AA or higher (49 enterprises)



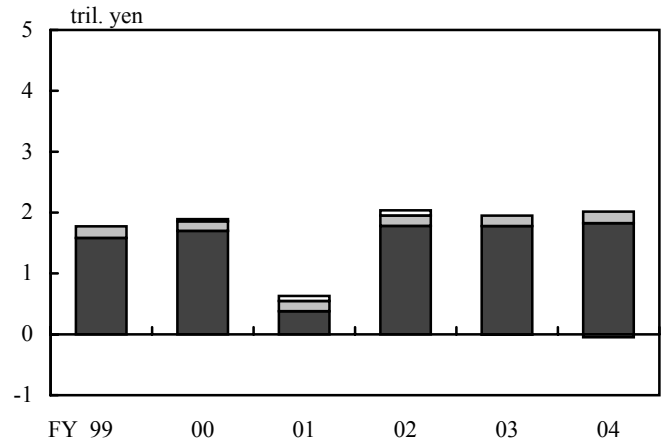


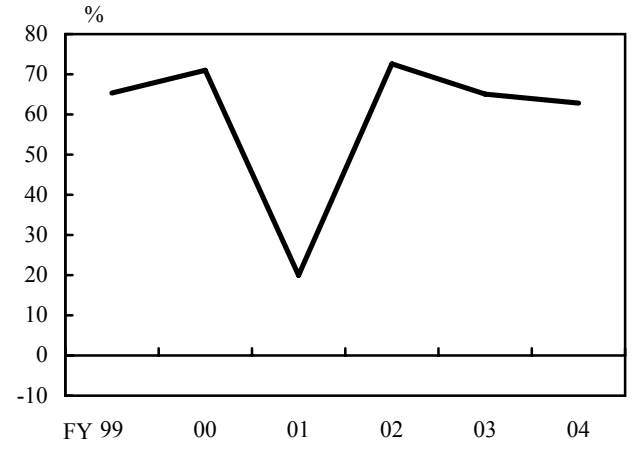
(2) Rating A (151 enterprises)





(3) Rating BBB (127 enterprises)

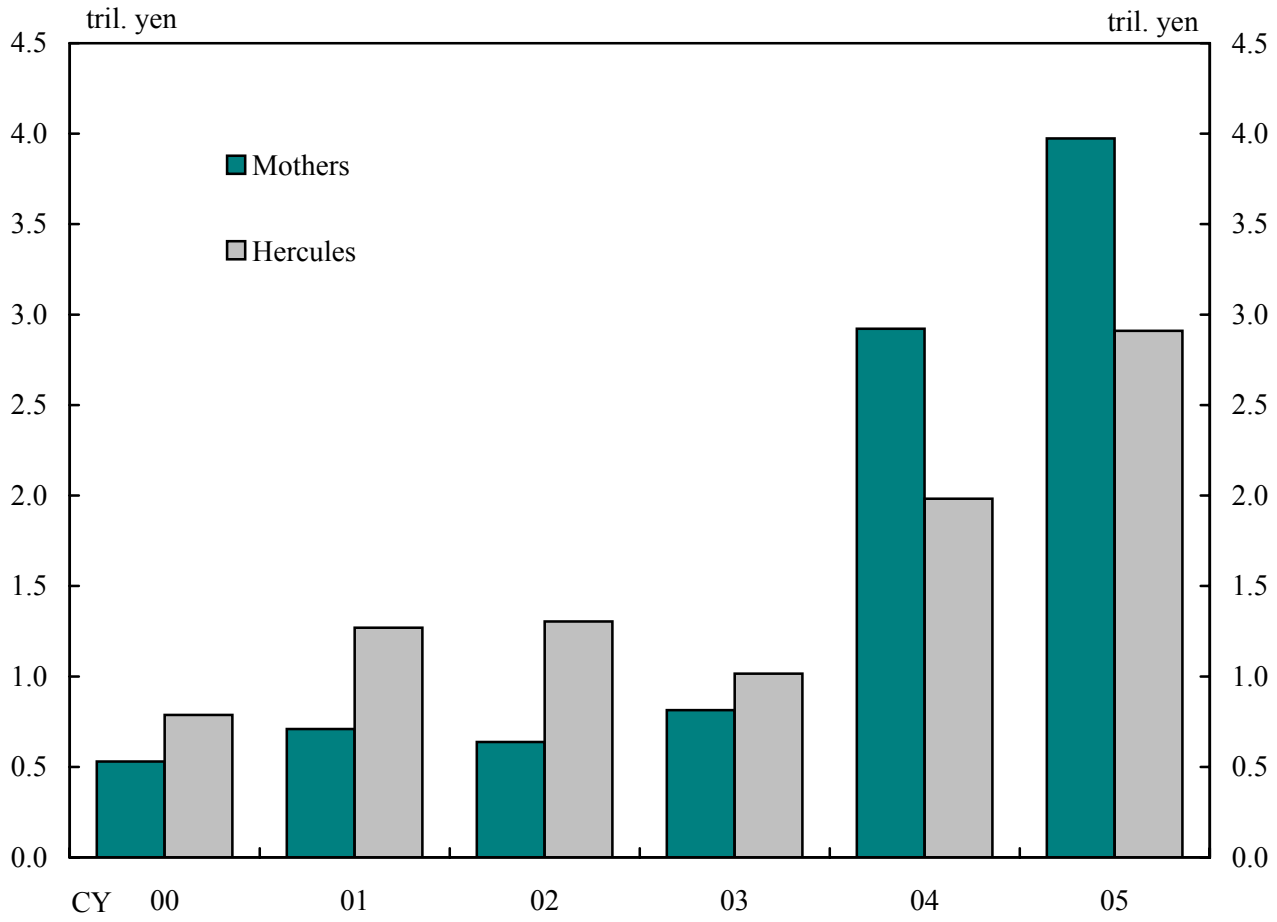




Note: Data are for 342 enterprises (excluding financial, electric and gas enterprises) which have continuously disclosed consolidated statements of cash flows since FY 1999 and received ratings from Rating and Investment Information, Inc. at the end of July, 2005. Those enterprises are classified by their ratings at the end of FY 2004.

Sources: Nikkei Financial QUEST; Rating and Investment Information, Inc.

Market Values of High-growth and Emerging Stocks

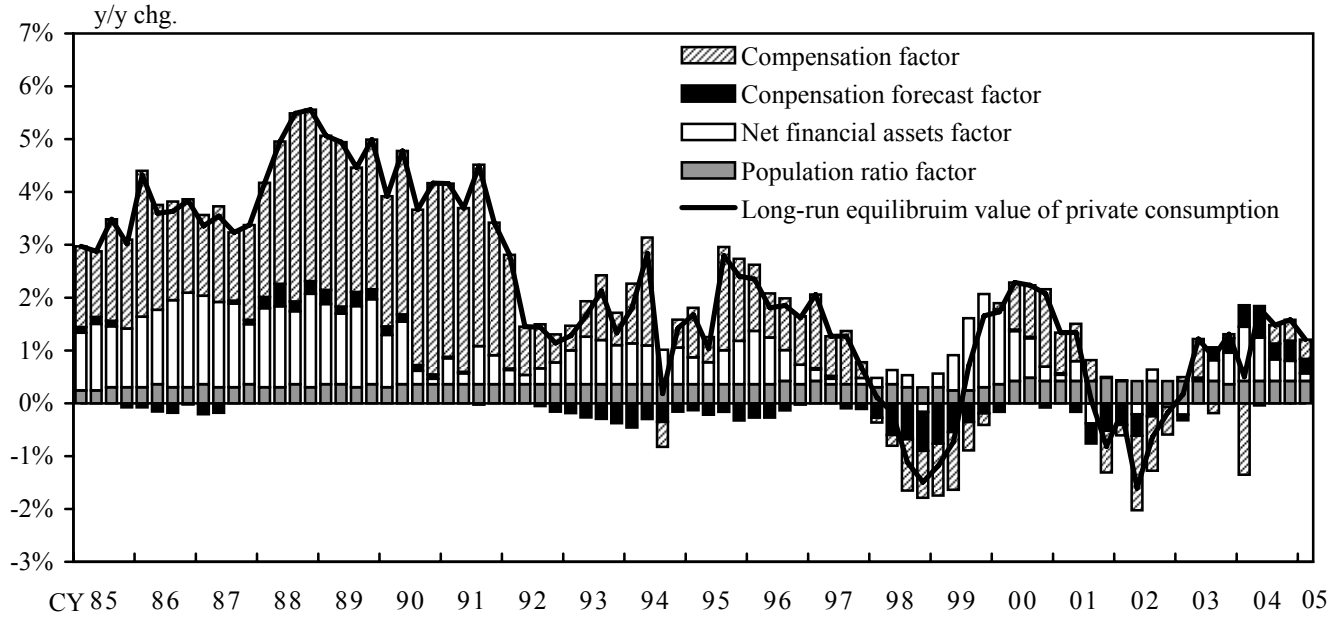


Notes: 1. Average market values at the end of every month.
2. CY 2000 figure for Hercules is the average from June to December. CY 2005 figues are averages from January to July.

Sources: Tokyo Stock Exchange; Osaka Securities Exchange.

Asset Effect on Private Consumption

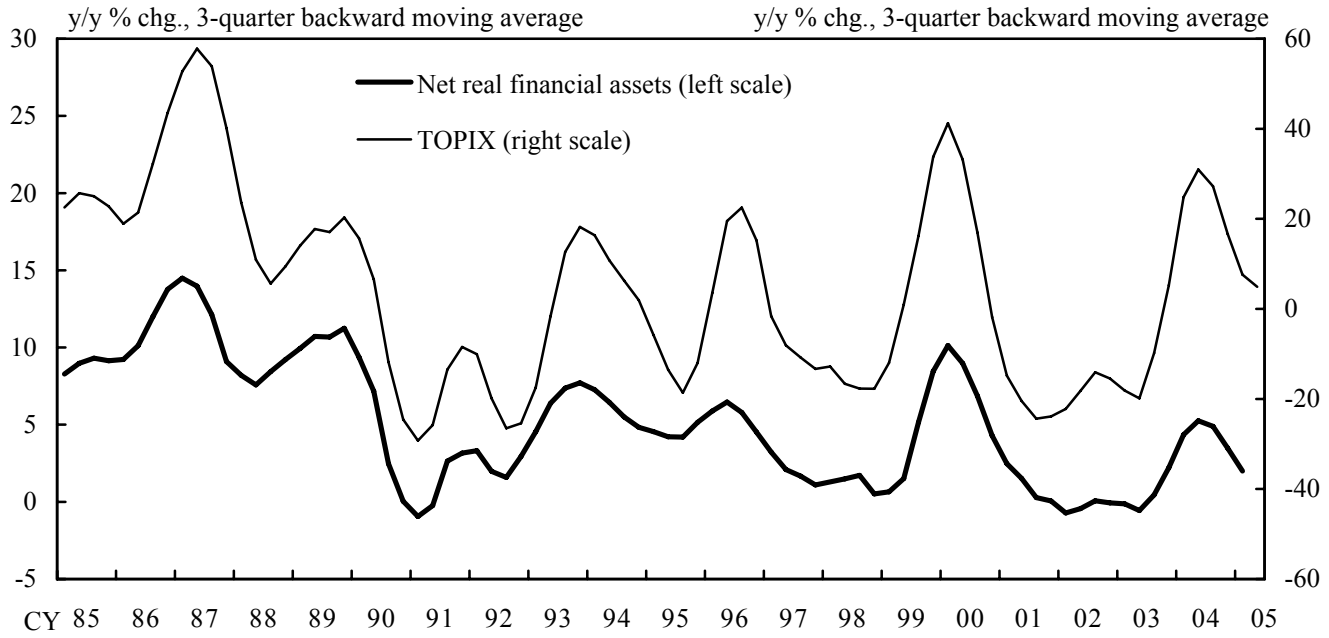
(1) Long-run equilibrium value of private consumption



ln (real private consumption) = 1.26 = {0.50 +0.10 × (1-unemployment rate)} × ln (real compensation of employees)
[0.13] [0.05] [0.029]
+ 0.01 × (percent of population over 60 years old) + 0.16 × ln (net real financial assets)
[0.001] [0.02]

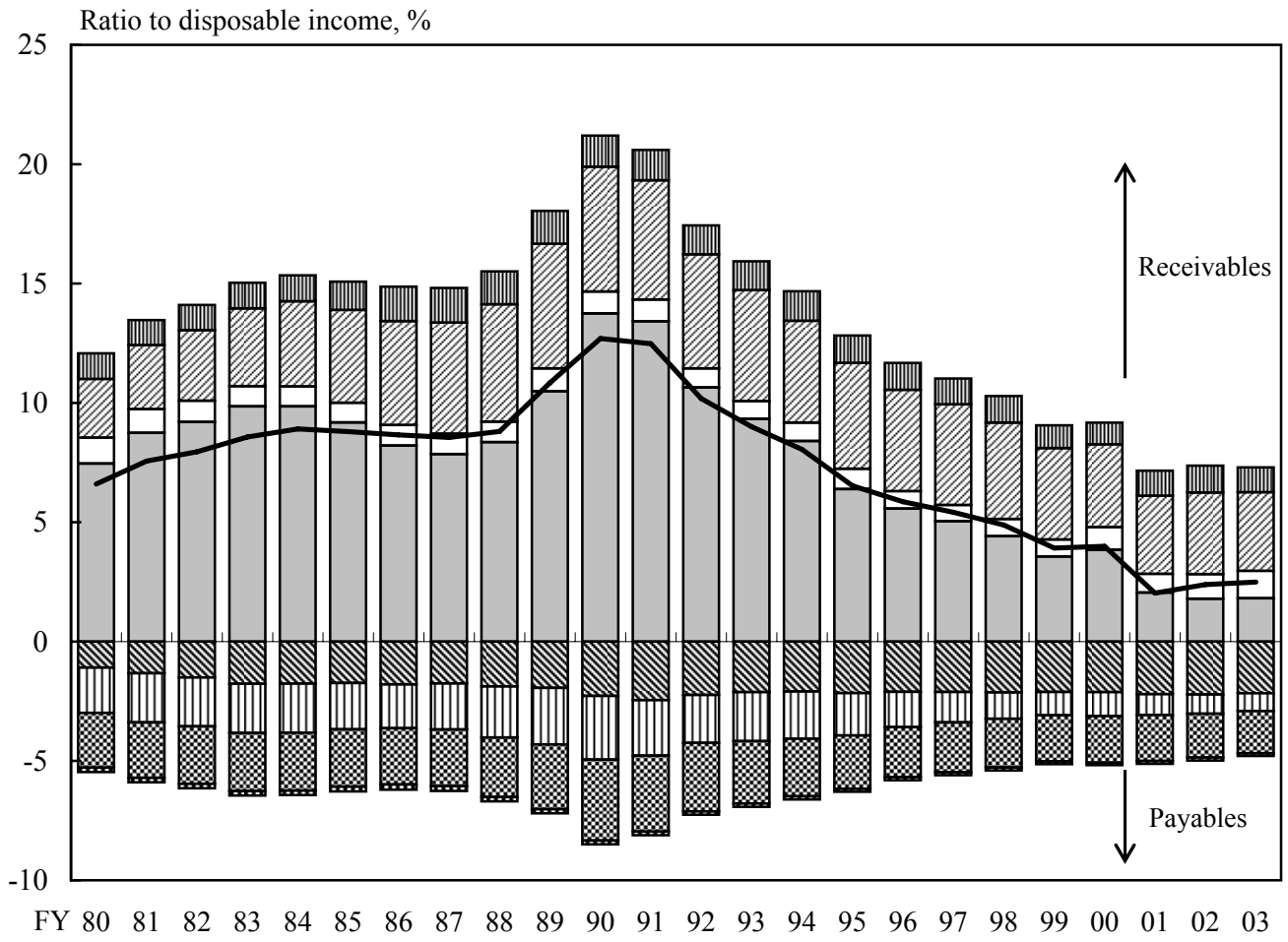
Notes: 1. Standard errors in square brackets.
2. Sample period: 1980Q1-2005Q1.
3. The product of (1-unemployment rate) and (real compensation of employees) is used as a variable for compensation forecast.

(2) Net real financial assets and stock prices



Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Population Estimates"; Bank of Japan, "Flow of Funds."

Net Property Income of Households

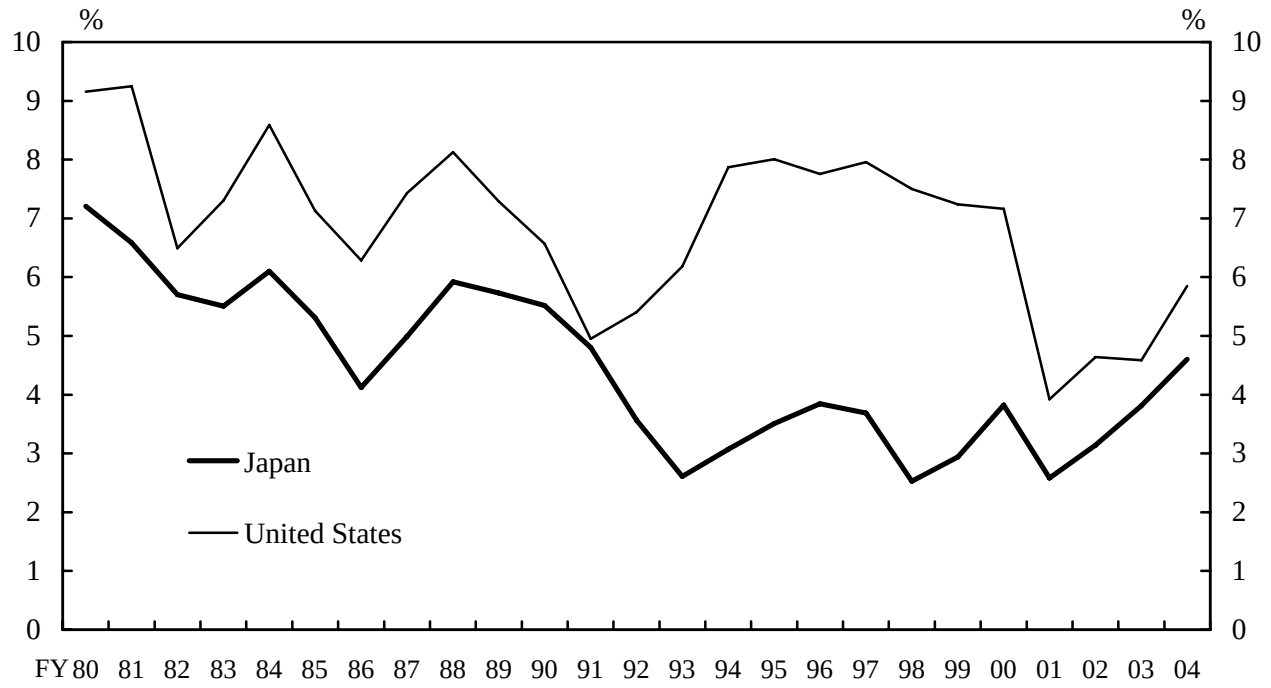


Payables	Rent
	Imputed service of owner-occupied dwellings
	Other industries
	Consumer debt interest
Receivables	Rent
	Property income attributes to insurance policy holders
	Dividends
	Interest
Receivables - payables	Net property income (nominal)

Source: Cabinet Office, "National Accounts."

Comparison of Profit Ratios in Japan and the United States

(1) ROA



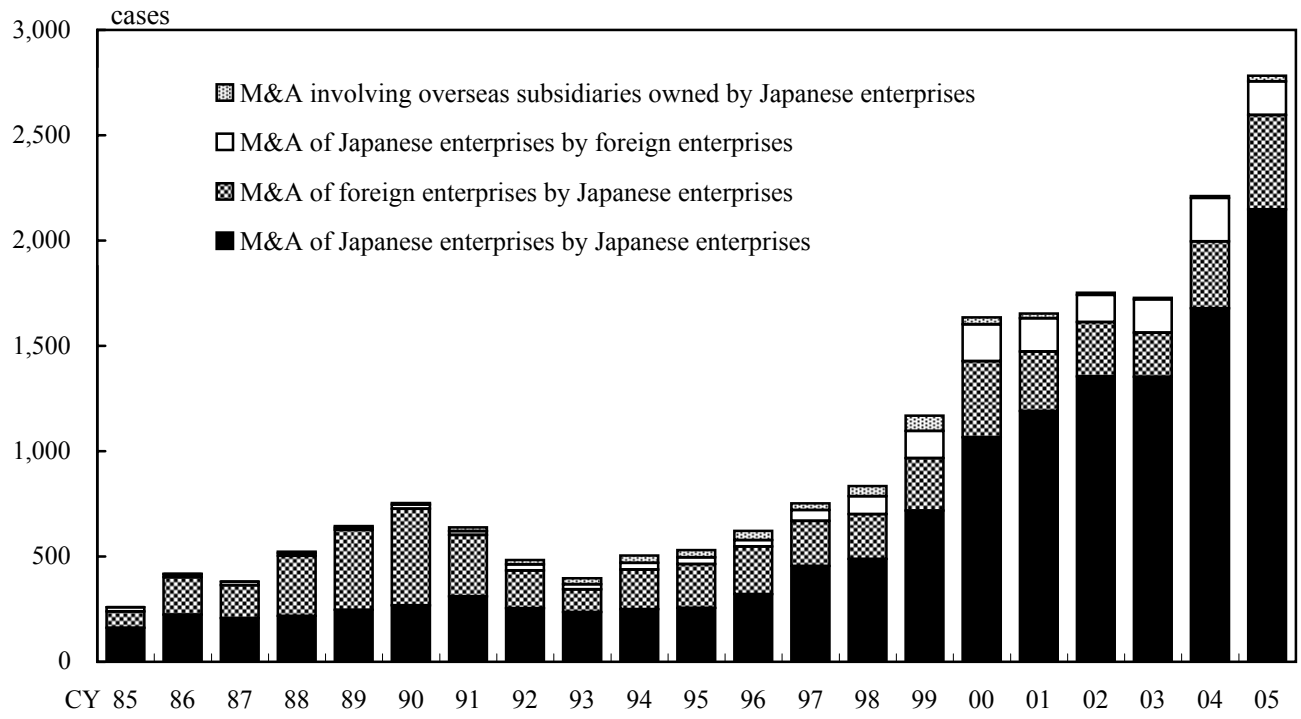
(2) ROE

Notes: 1. Data are for manufacturing enterprises. FY for Japan, CY for United States.
2. ROA = operating income (income from operations) / total assets.
3. ROE = income before income taxes / stockholders' equity.

Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually";
U.S. Department of Commerce, "Quarterly Financial Report."

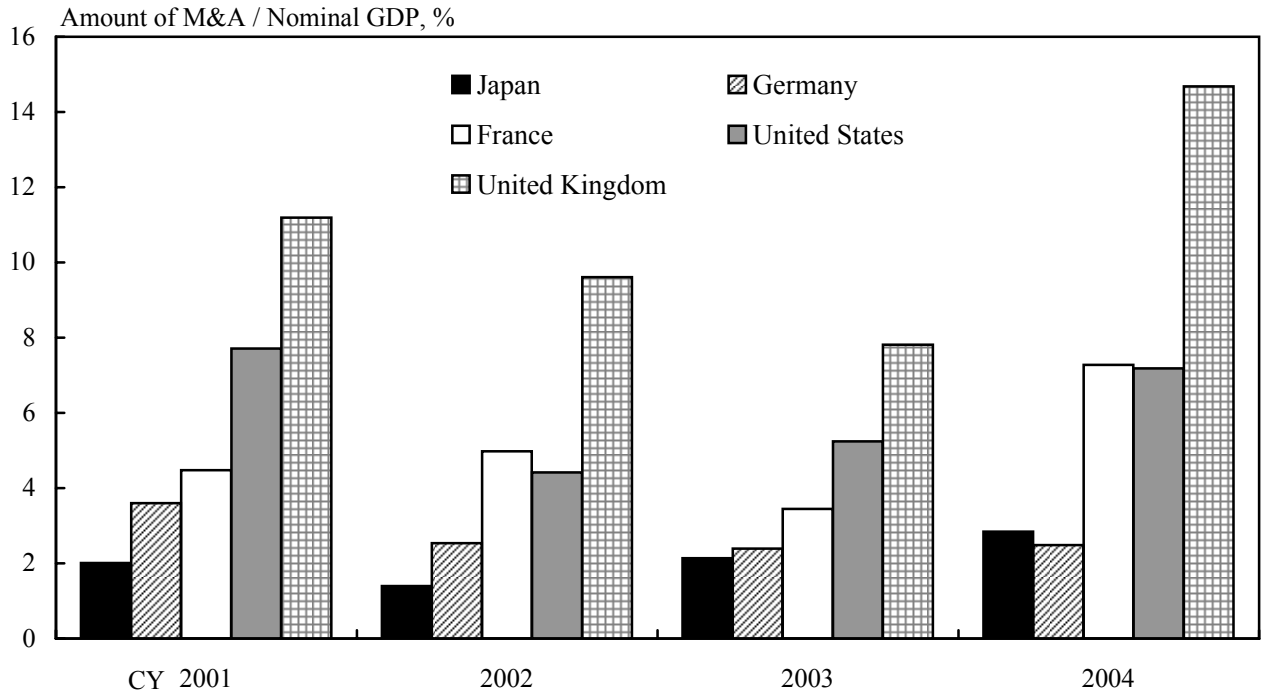
M&A

(1) Number of M&A cases



Notes: 1. M&A among group companies are excluded, while those related with financial institutions are included.
2. Figures for 2005 are those of January-July in terms of annual amount.

(2) Amount of M&A



Notes: 1. Nominal GDP is based on purchasing-power-parity (PPP) valuation by IMF.
2. M&A includes mergers and acquisitions of enterprises, minority stake purchases, and debt restructuring, but excludes stock repurchases.

Sources: RECOF; Thomson Financial.