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January Rebound in Spending and Output Not Enough To Regain Lost Momentum

Rebounds in industrial production, consumption, and housing starts as well as a modest rise in employment in January have led some to believe Japan's economy may be recovering from the last three quarters of contraction. But we fear the rebound will be short-lived, given the still-bleak government outlook for industrial production, and the doubtful accuracy of consumption data.

The Ministry of Economy, Trade and Industry (METI) announced that industrial production rose 2.1% month-over-month in January, up for the first time in two months and the highest reading since April 2004. The agency's outlook, however, shows successive month-over-month declines in industrial production of 0.5% in February and 1.0% in March. Moreover, February and March production could post even larger declines, given the fact that actual outcomes tend to fall short of the METI outlook (January's result was weaker than the METI forecast of 2.8%).

On a year-over-year basis, growth in industrial production posted a bleak 1.1% in January. This was lower than November's 4.5% or December's 1.8%, and excluding October's -0.8%, the worst showing since August 2003 (**Display 1**).

The outlook for growth in industrial production in coming months isn't so bright when viewed on a year-over-year basis, either. As we mentioned, the METI expects negative month-over-month growth in both February and March. These numbers can be translated into year-over-year growth of 1.8% for February and 1.6% for March.

Reinforcing our view that industrial production growth has not bounced back is export volumes, which fell for the first time in 19 months. The decline of 3.2% year-over-year in January was the largest fall in nearly three years (**Display 2**).

Another indication that January's rebound was just temporary are results of the latest Shoko Chukin Bank survey of small and medium-sized firms. The outlook for year-over-year growth of sales for the manufacturing sector points to a decline of 2.8% in the month of March, the first decline in two years and four months (**Display 3**).

Consumption Rebound Could Be a One-Off

Meanwhile, according to the salaried-workers' household survey for January, real consumption spending grew 2.6% year-over-year, the highest reading in six months.

This hike could be a one-off, however. In December, the series experienced a drastic fall of 3.8%, the largest drop in three years and a 24-year low for sales in the month of December. While cold weather and the marginal rise in disposable income of 0.9% might have helped to boost household consumption in January, we think it highly likely that household consumption worsens back to negative growth territory in February.

Moreover, defects in the salaried-workers' household survey lead us to believe that January figures could be distorted. As mentioned in prior commentaries (see this publication of January 18, 2005) sample numbers are too small, with only 7,000 households represented in the overall household survey and only 4,500 represented in the salaried-workers' household survey. Distortions are observed particularly in spending on durable and luxury goods, for which the survey tends to show a high volatility. For example, the January household survey showed that car purchases (the single most expensive item for households) saw erratically strong growth of 74.9% year-over-year. This doesn't make sense when compared with retail sales figures released by the METI, wherein passenger car sales dropped 0.4% year-over-year in the month (**Display 4**).

And, excluding car purchases, year-over-year growth in household spending becomes a

significantly lower 1.5%, a minor pickup compared with December's huge 3.8% decline.

Slight Improvement in Employment Seems Unsustainable

Although the unemployment rate remained unchanged at 4.5% in January, overall employment jumped 0.6% year-over-year in the month after flat growth in December (**Display 5**). Within this, corporate employment was flat year-over-year, after falling for the first time in 14 months in December.

Corporate employment has been on a downtrend since May of last year, implying that the corporate sector in general is not hiring employees (**Display 6**). New job offers rose only 8.8% year-over-year in January, a pronounced slowdown from respective gains in November and December of 21.6% and 8.8%.

Meanwhile, self- and family-employed workers' employment was up by 4.4% year-over-year, the highest rise since May 1978. In our view, it is doubtful that such an erratic jump could be sustainable.

Housing Starts Not Meaningful for Outlook

In an admittedly significant turnaround from -2.0% in December, January housing starts rose a robust 6.9% year-over-year despite being off of respective

growth in July, August and September of 7.8%, 10.5% and 10.1%.

Yet because housing starts are a very volatile data series, the analysis of a single month's data is not meaningful for the outlook (**Display 7**). Indeed, we do not believe that January results are enough to suggest that the economy is moving in an encouraging direction. Rather, we remain cautious on housing investment for the year ahead, when we anticipate a drastic reduction in the tax benefit on housing loans.

Conclusion: Our Outlook Remains Unchanged

All told, we maintain our cautious view on the Japanese economy. Our GDP forecast for 2005 remains unchanged at 0.3%, a significant decline from 2004's overall growth of 2.6%. We expect industrial production to decline 0.9% in 2005, also a significant deterioration from 2004 performance, which was 5.6% for the year overall. With our economic scenario thus unchanged, our six-month target of the 10-year JGB yield is also unchanged at 1.20%.

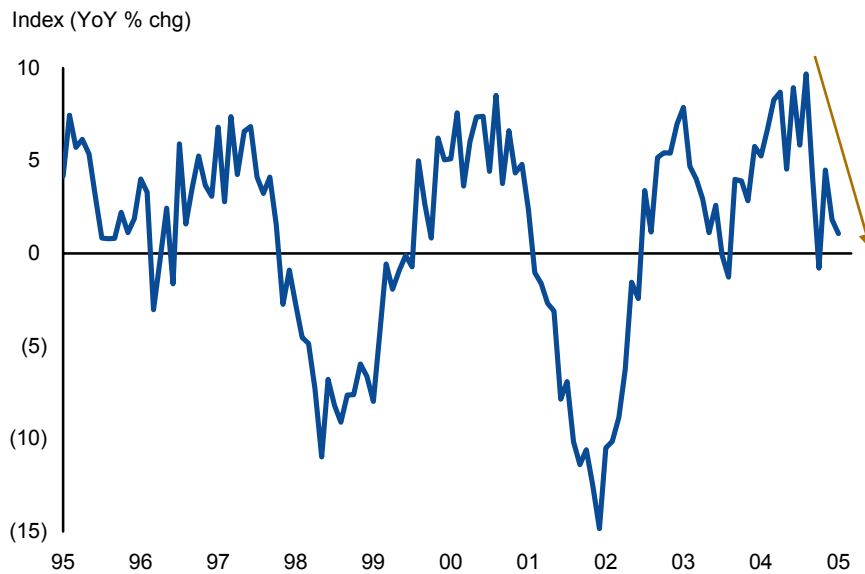
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March 8, 2005*

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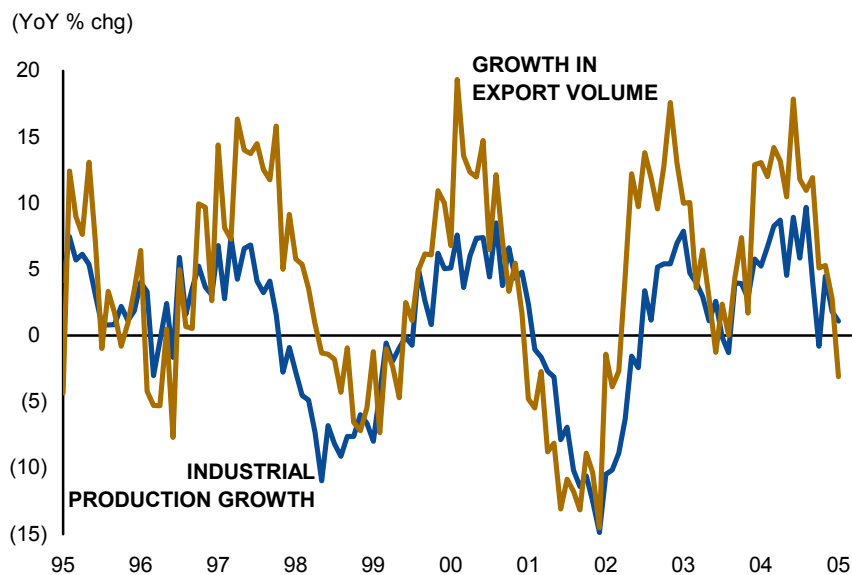
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Display 1: On a Year-over-Year Basis, January's Growth in Industrial Production Still on a Downtrend
Industrial Production Growth



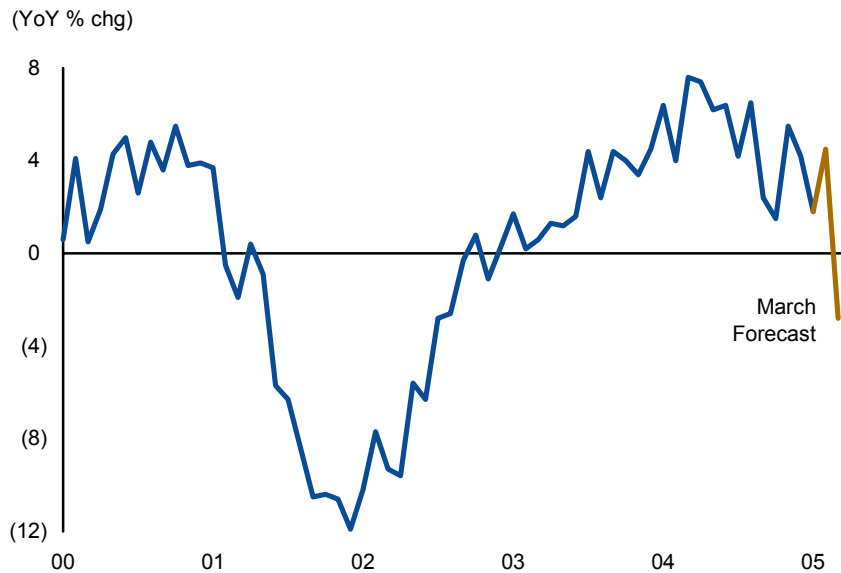
Source: Ministry of Economy, Trade and Industry. March 8, 2005

Display 2: On a Year-over-Year Basis, January's Export Volumes Saw the First Fall in 19 Months
Export Volumes and Industrial Production



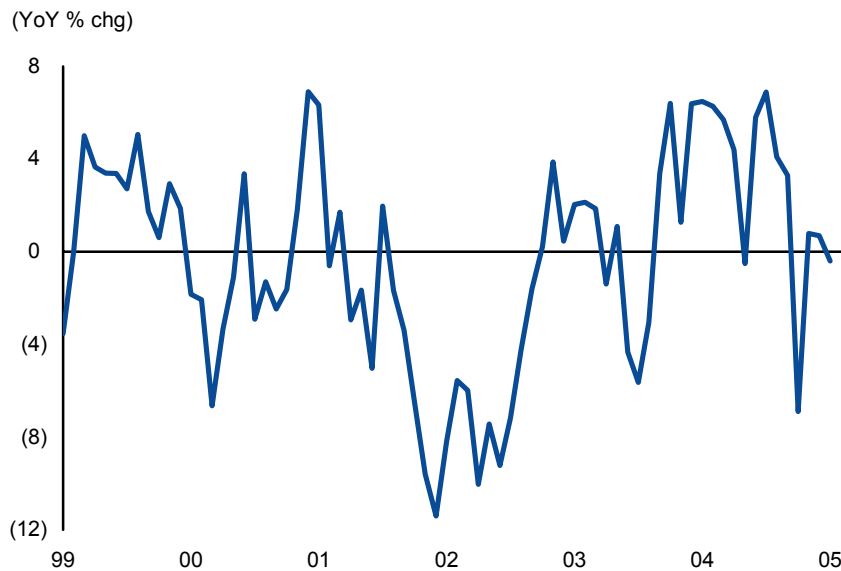
Source: Ministry of Economy, Trade and Industry, Ministry of Finance, March 8, 2005

Display 3: Outlook for March Industrial Production Very Bleak
Manufacturers' Sales Growth: Shoko Chukin Bank Survey on Small Firms



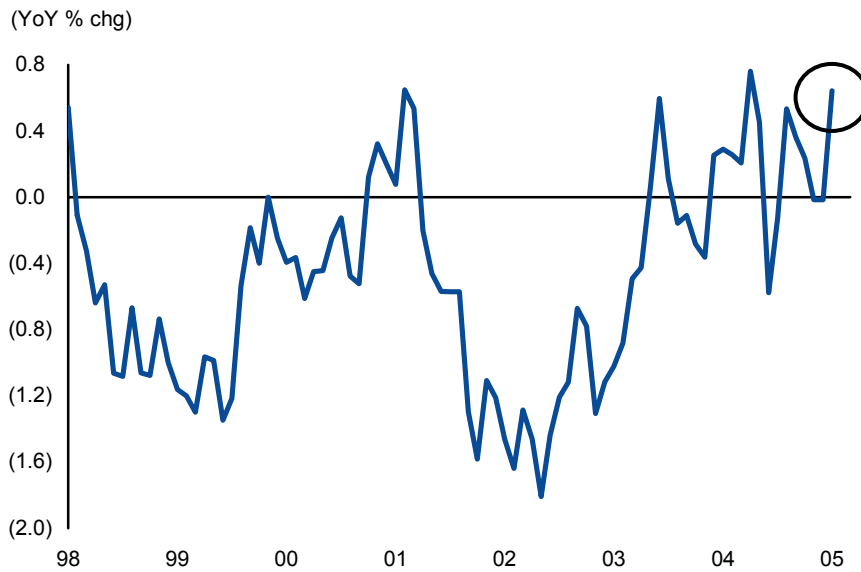
Source: Shoko Chukin Bank, March 8, 2005

Display 4: Passenger Car Sales Sluggish
Growth in Passenger Car Sales



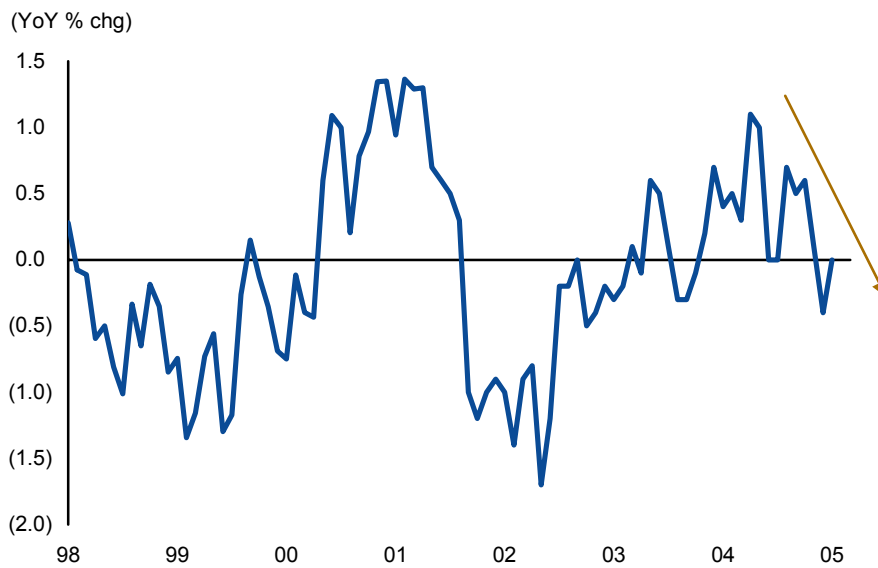
Source: Ministry of Economy, Trade and Industry, March 8, 2005

Display 5: Self- and Family-Employed Workers Boosted Overall Employment in January
Overall Employment



Source: Ministry of Internal Affairs and Communications, March 8, 2005

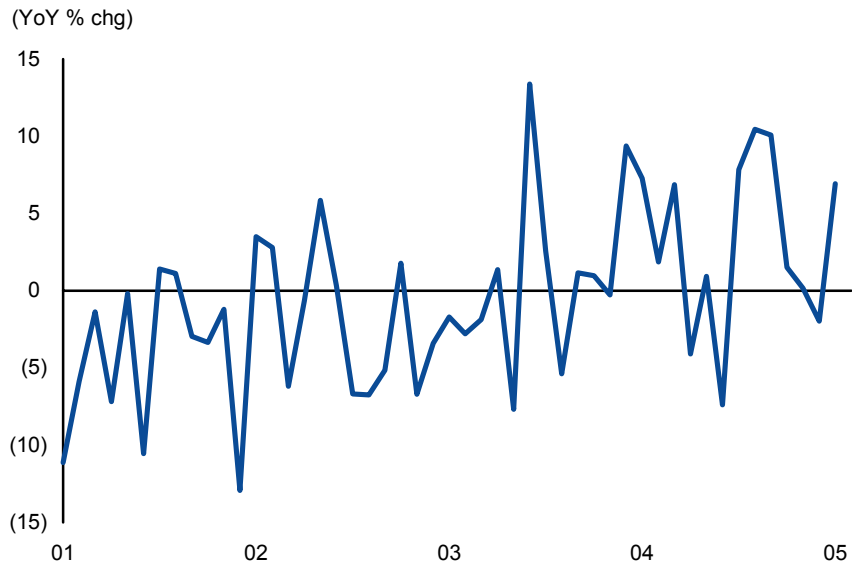
Display 6: Corporate Employment Remains on a Downtrend
Growth in Corporate Employment



Source: Ministry of Internal Affairs and Communications, March 8, 2005

Display 7: Housing Starts Series Is Volatile

Housing Starts



Source: Ministry of Land, Infrastructure and Transport, March 8, 2005