

# JAPAN ECONOMIC WEEKLY



July 15, 2005

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# Japan Economic Perspectives

## A Virtuous Cycle—Brought on By Yen Weakness—Buoy Consumption

Although a heavier individual tax burden may put household disposable income under pressure next year (see this publication dated July 1, 2005), it could be offset by the marked improvement in labor, wages and sentiment that has transpired in recent months. Indeed, a virtuous cycle may be developing, triggered by the weaker yen, which could help to mitigate consumption concerns—at least for the rest of this year. That is, the weaker currency affects manufacturer sentiment, which is followed by higher manufacturing employment, which in turn strengthens consumption, which affects non-manufacturing sentiment in consumption-related sectors, which is followed by higher non-manufacturing employment and hence, even greater consumption.

Admittedly, underlying private consumption trends are still weak, as real salaried-workers' household consumption of goods and services declined 3.1% and 2.0% year-over-year in April and May, respectively (**Display 1**). Nonetheless, the fact that the April-May average on a seasonally-adjusted basis was 0.7% higher than the first quarter average plausibly points to stabilizing consumption, in our view. Moreover, retail sales data indicate that consumption may be undergoing a transformation. Retail sales growth reached an eight-year high of 3.8% year-over-year in April, followed by further solid growth of 2.7% in May (**Display 2**). While some of the growth is accounted for by surging oil prices, sales growth in other sectors has been positive as well. Auto sales in particular have been robust, showing respective growth of 10.7% and 7.5% in April and May—possibly signaling the start of a pronounced upturn in consumer sentiment.

Already, non-manufacturing business sentiment is receiving a boost from consumption-related sectors. The diffusion index of non-manufacturers' business conditions advanced to a 13-year high of 15 in the June Bank of Japan Tankan Survey, after moving

sideways at 11 for three successive quarters. And, though the rise in the index was due to increases in information services, real estate and transportation as well as individual services and retail, business conditions for the latter two sectors were particularly impressive (**Display 3**).

Our analysis suggests that the cycle started when improved manufacturer sentiment brought about by a weakening yen led to a sharp rise in employment. Indeed, since the start of the year, manufacturing employment trends have improved in tandem with the weakening yen (**Display 4**). The positive effects seem to have spilled over into corporate employment, which has risen steadily from March through May, amounting to a cumulative 770,000 in new corporate jobs (**Display 5**).

Finally, stabilizing wage income is undoubtedly helping consumption. In May, the average cash salary for all industries rose 0.4% year-over-year—marking four out of five months with positive growth this year (**Display 6**). While salaries can be broken down into three parts—base salary, overtime pay and special compensation (e.g., bonuses)—base salaries entered positive growth territory in April and May for the first time since November 2000 (**Display 7**). According to our analysis, this reflects not only higher wages, but also a shift from part-time to full-time work, which we believe is proof of improving corporate sentiment. To be sure, base salaries generally are higher for full-time employees than for part-time. Moreover, after seven successive years of decline, full-time employment has registered positive year-over-year growth since January, while growth in part-time employment declined for the first time in ten years in April and May (**Display 8**).

Thus, although a heavier individual tax burden still causes some worry over future consumption trends, the support of the emerging virtuous cycle is making prospects somewhat more sanguine—for this year, at any rate.

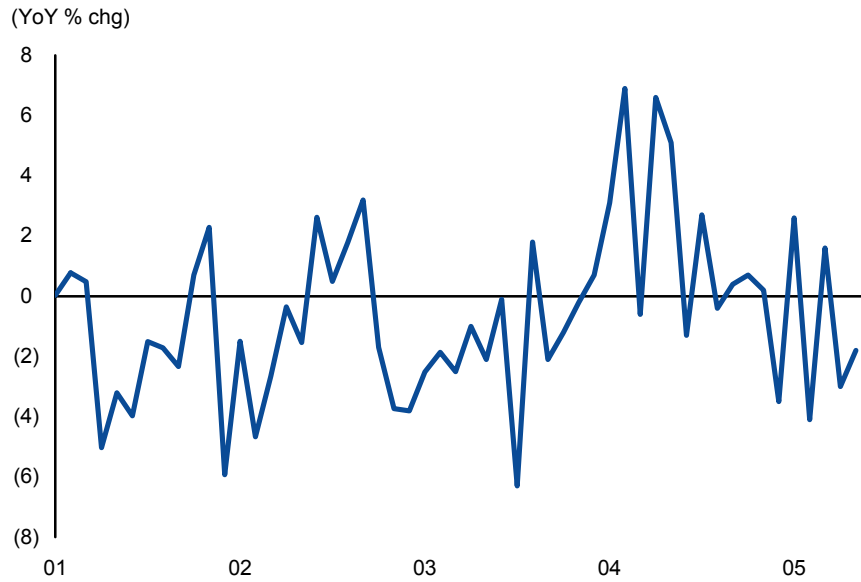
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July 15, 2005*

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## Display 1: Household Consumption Remains Weak, But Shows Signs of Bottoming

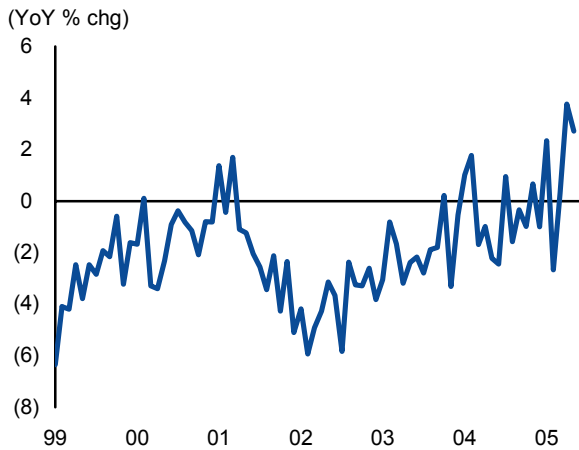
### Growth of Salaried-Workers' Household Spending



Source: Ministry of Internal Affairs and Communication; July 15, 2005

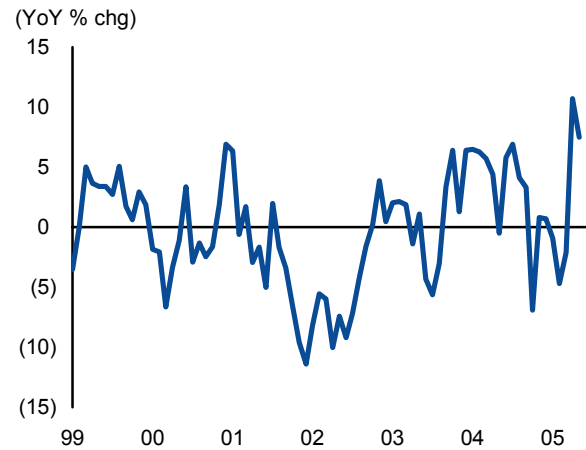
## Display 2: Retail Sales Showed Robust Growth in April and May, In Part Due to Growth in Auto Sales

### Retail Sales Growth



Source: Ministry of Economy, Trade and Industry; July 15, 2005

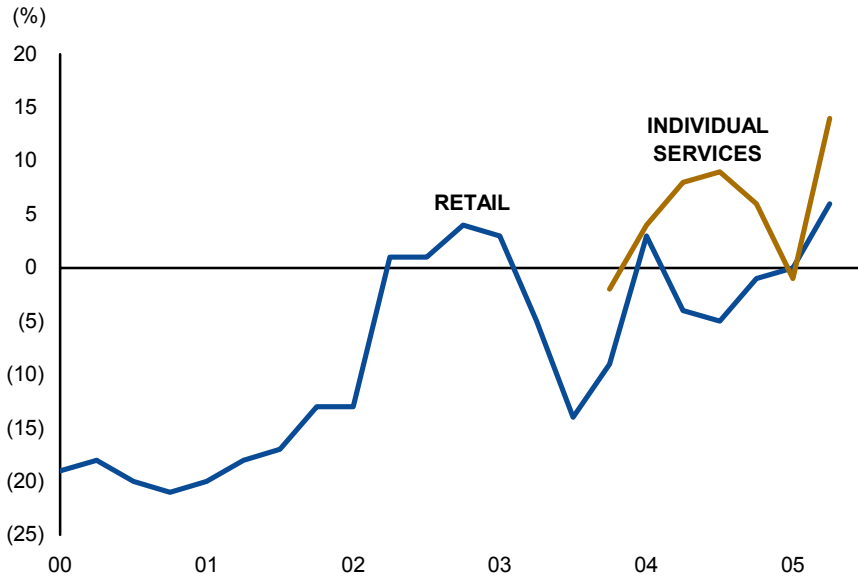
### Auto Sales Growth



Source: Ministry of Economy, Trade and Industry; July 15, 2005

### Display 3: Business Conditions Are Improving in Consumption-Related Sectors

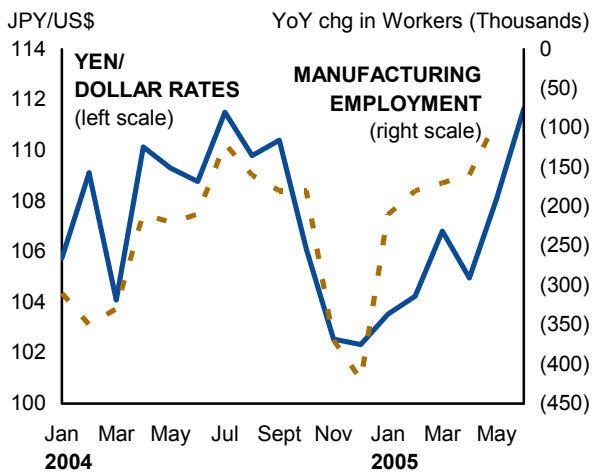
Diffusion Index of Non-Manufacturers' Business Conditions: Retail and Individual Services Sectors



Source: Bank of Japan; July 15, 2005

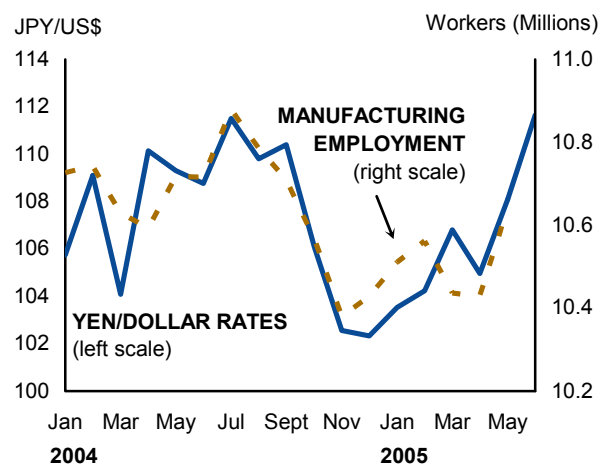
### Display 4: Manufacturing Employment Has Been Improving in Tandem with the Weakening Yen

Growth of Manufacturing Employment vs. Yen/Dollar Rates



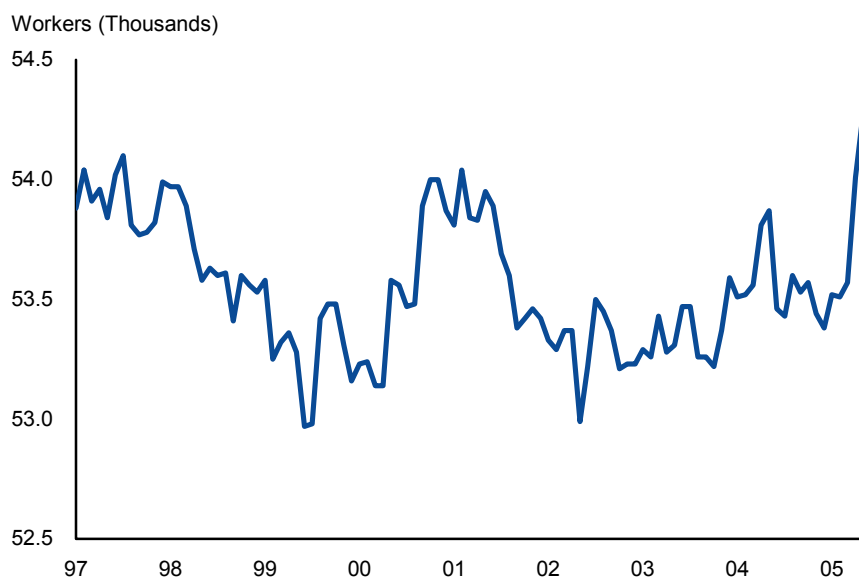
Source: Ministry of Internal Affairs and Communication, Alliance Capital Fixed Income; July 15, 2005

Seasonally Adjusted\* Manufacturing Employment Levels vs. Yen/Dollar Rates



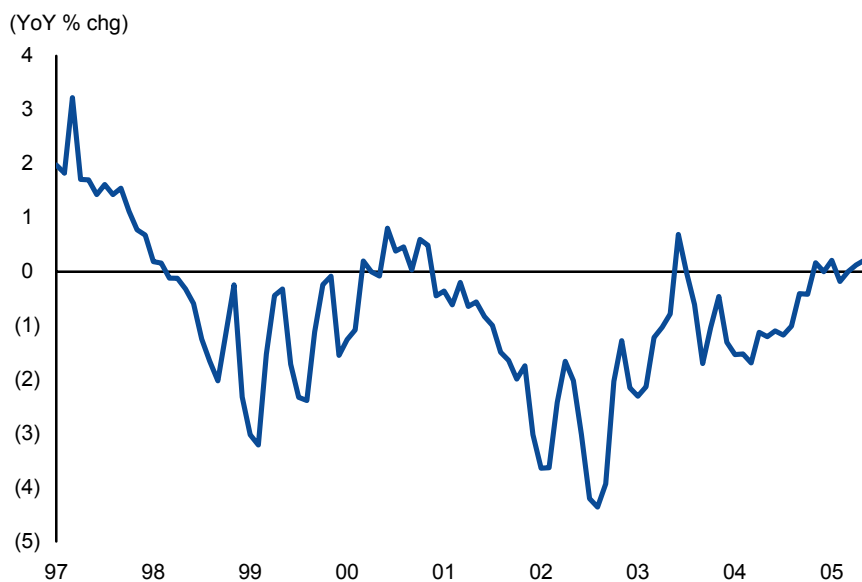
\*Seasonally adjusted by Alliance Capital Fixed Income  
Source: Ministry of Internal Affairs and Communication, Alliance Capital Fixed Income estimates; July 15, 2005

**Display 5: Corporate Employment Increased Sharply in April and May**  
 Seasonally-Adjusted Corporate Employment



Source: Ministry of Internal Affairs and Communication; July 15, 2005

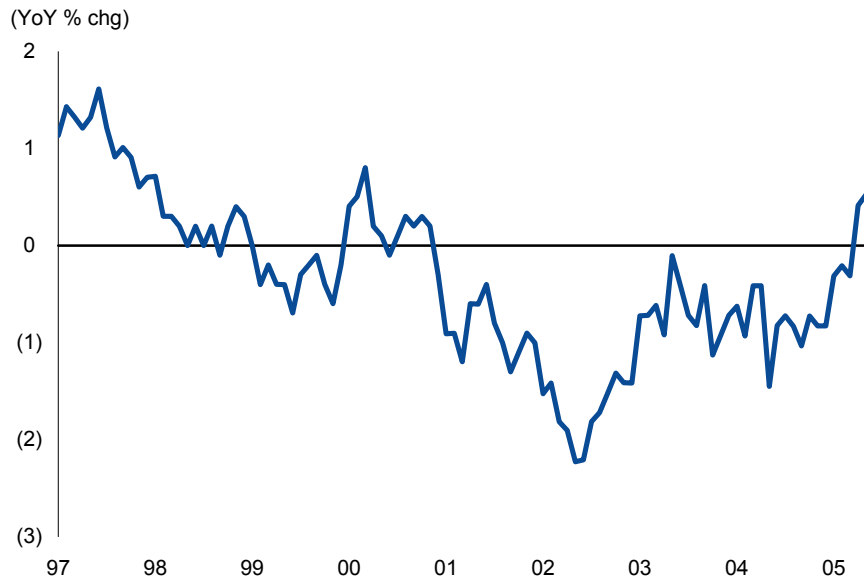
**Display 6: Wage Income Appears to Be Stabilizing**  
 All-Industry Average of Total Cash Salaries (3-Month Moving Average)



Source: Ministry of Health, Labor and Welfare; July 15, 2005

### Display 7: Base Salaries Are Rising

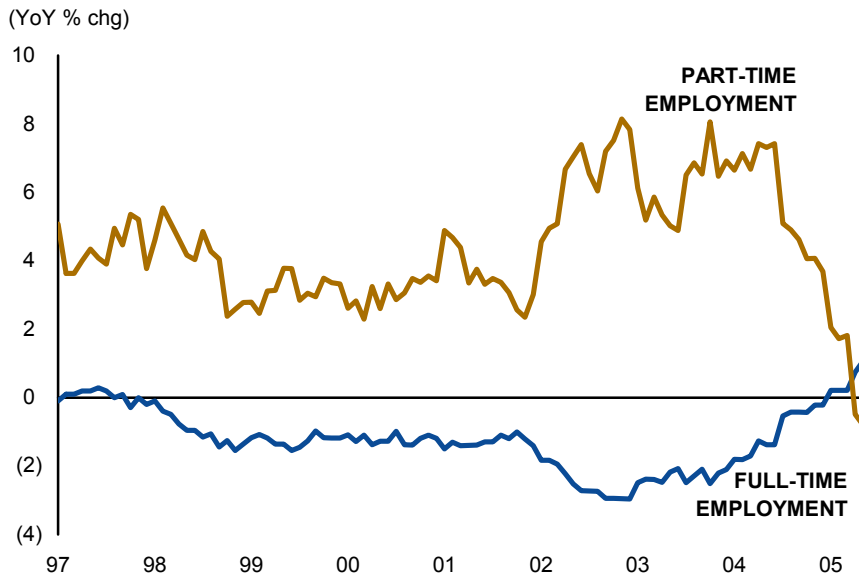
#### All-Industry Average Base Salaries



Source: Ministry of Health, Labor and Welfare; July 15, 2005

### Display 8: Employment is Shifting from Part-Time to Full-Time

#### Full-Time and Part-Time Employment



Source: Ministry of Health, Labor and Welfare; July 15, 2005