

HIGHER INTEREST RATE GAP LIKELY BETWEEN U.S. AND JAPAN

U.S.: Getting Closer to Fed's Rate Hike

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Fresh signs of solid first-quarter growth were noticeable in recent economic data. A weather-related jump of 339,000 in February nonfarm payroll employment combined with a big increase in the work week left the increase in aggregate hours consistent with first-quarter growth at around 3~3.25%. The manufacturing sector fared well, judging from the February jobs report, purchasing managers survey and the healthy increase in January factory orders. February auto sales totalled 15.3 million units, off a bit from January but still strong, and chain-store sales posted respectable gains. High consumer confidence and a big jump in January credit card debt show that the consumer-led growth still has its power. New home sales were at an eleven-year high, and another increase in the January index of leading indicators signaled more growth ahead.

There is a dilemma for the Fed here. Economic growth clearly exceeds its long-run potential, and the tight labor market skews inflation risks upward. Yet there is still no evidence of price pressures at the finished-goods level. The PPI report for February shows once again that inflation remains very much in check.

However, we believe that the FOMC meeting in March or May would be a great time to execute a preemptive strike against potential inflation risks, even though it is especially difficult to ignore politicians' complaints against raising interest rates when current inflation remains so tame. Recently, Alan Greenspan, the Fed's chairman, also said that the Federal funds rate could possibly be raised soon to keep the overheated financial markets steady.

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Japan: No Possibility of BOJ's Rate Hike Because of Problematic Pessimism

The latest major reading on the Japanese economy was impressive. Real GDP in the final quarter of 1996 grew 3.9% from the previous quarter on an annual basis. Consumer spending grew 4.9% in the quarter, reversing two straight quarters of decline. In addition, private housing investment surged 17.2% and private capital spending increased 6.8%. This rise in private sector demand more than offset the negative impact of the 13.2% shrinkage in the public sector. Meanwhile, net exports have almost tripled from the previous quarter.

The problem, however, is that skepticism about the future remains high. Even though Japanese government officials are striving to build confidence in the economy, the consumer and business sentiment indices suggest that the economy could lose much momentum soon. The skepticism has been caused mainly by the scheduled tax hikes and reductions in government investment that will make private domestic demand and the general economy slow down in the coming months. The increased risk of economic slowdown is amply reflected by the recent decline in the 10-year government bond yield to a new historical low of below 2.3%. The government seems to believe that the pessimistic expectations are excessive and could become self-fulfilling. Therefore, we expect that the Bank of Japan will not raise its discount rate in the near future to keep consumer and business sentiment high. **VIP**

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