U.S. & JAPAN - WHETHER OR NOT TO RAISE

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U.S.: Fed's Monetary Policy Still in Tightening Mode

Recently, there has been evidence of a slowdown in second quarter growth. Warnings of tight labor market conditions in the Fed's "Beige book" survey of regional conditions were overshadowed by reports of moderate economic growth and subdued wage pressures through April. Signs of slower growth continue to center on the consumer, the main engine behind the first quarter boom. The pace of April chain-store and auto sales slowed, the latter to an eighteen-month low. Some of the weakness may have been a temporary response to increased tax payments, unseasonably cool weather and a limited supply of certain cars as a result of the auto strike.

Moreover, recent increases in initial claims for unemployment insurance, even after adjusting for flooding and increased auto strike activity, could signal a further slowing of the employment gains that fueled rapid income growth earlier this year.

In addition to this evidence, the recent price reports gave some comfort for the Fed to forego monetary tightening at the FOMC meeting on May 20. The PPI tumbled an unexpected 0.6% last month, while the core measure fell 0.1%. Another good reading was that the CPI rose only 0.1% in April.

However, we believe that the Fed's decision at the May 20 FOMC meeting to maintain its current stance is more likely just a delay in further rate hikes than a return to a neutral monetary policy stance. In other words, it is too early to conclude that a sufficient economic slowdown is on track because GDP growth still looks likely to average at least 3.5% in the first half of 1997 and lagging inflation is normal.

Japan: Overpowered Rumors on Early Official Interest Rate Hikes

Major changes are afoot in the Japanese financial market recently. In the foreign exchange market, the Japanese yen has appreciated sharply against the U.S. dollar, from around 127 yen per dollar to about 112 yen. Meanwhile, the ten-year government bond yield has surged from an all-time low of 2.1% in early April to around 2.6% recently.

The sharp market movements were ignited mainly by bullish words on the yen from senior officials of the Ministry of Finance and speculation that the Bank of Japan (BOJ) would raise interest rates as soon as July.

However, we see little chance that the BOJ will tighten its monetary policy until later this year. The recent surges in market interest rates and the strengthening of the yen have greatly reduced the need for the BOJ to become more restrictive.

More importantly, the central bank remains unconvinced that the nation's economy has achieved self-sustainable growth. BOJ officials are likely to leave key interest rates unchanged until they have concrete evidence that the recovery can move ahead under its own power, without unusual stimulus measures. On that score, the weaker data, including a 12.7% drop in domestic machinery orders in March and the slumping auto sales in April, indicate that the foundation of the upturn remains a bit shaky. VIP