

U.S. & JAPAN: STRONGER STEPS NEEDED

by Sung-soo Yang
(e-mail: yangss@hri.co.kr)

The U.S.: the Fed Moves Again

As domestic consumption temporarily increased, the U.S. third quarter growth rate was 3.3%, much higher than the 2.1~2.2% most economists expected. But the latest economic data show some counter-evidence. Job growth is at a three-year low, and the slowdown in employment will inevitably lead to a stagnation in income growth. Meanwhile, the industrial sector is going from weak to weaker. The purchasing managers index (NAPM) slipped to 48.3 for October, the fifth consecutive month low. Furthermore, the new orders component dropped to a three-year low, and the inventory component jumped to a 10-year high. Industrial production has been flat this year and seems to be getting ready to decline.

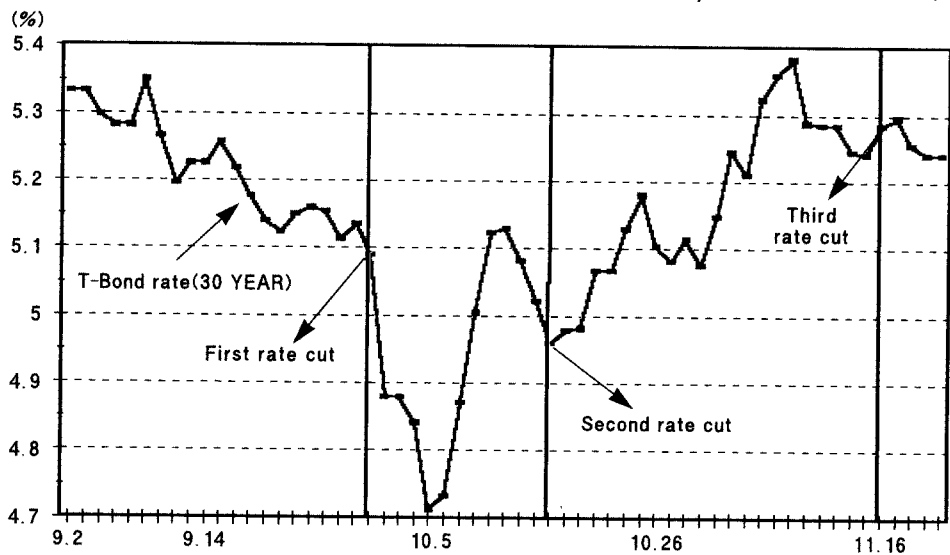
Therefore, the Federal Reserve decided to cut

short-term interest rates for the third time in seven weeks, hoping to immunize the U.S. against recession and further financial market disruptions. However, worries about a credit crunch remain, even though conditions have improved since the Fed's mid-October emergency rate cut. Even after the rate cut, lower-credit-rated industrial companies were still having to pay about 0.6 percentage points more than higher-credit-rated competitors to issue short-term commercial paper. That was not as bad as the mid-October peak of 0.75 percentage points, but it was four times the gap that existed for much of the year.

The question now is whether or not the Fed will conclude that they have acted sufficiently to protect the U.S. from the danger of a credit crunch and the ill effects of the Asian financial crisis. Although the economy remains strong

"The question now is whether or not the Fed will conclude that they have acted sufficiently."

<Figure> Short-term Trends of the U.S. Treasury Bond Rate(30Y)



now, it is widely expected to weaken in the coming months, especially as recession spreads to Latin America and further exacerbates the U.S. trade deficit. Indeed, the OECD expects U.S. GDP growth in the first half of 1999 to slow to a seriously weak 0.9% annualized pace, before rebounding later in the year. Furthermore, the Fed also faces less danger in cutting rates than before because inflation remains dormant. Therefore, it is possible that the Fed may lower the rates to 4.5% or lower in the next six months.

Japan: Stimulus Package Fails To Excite Investors.


Even a 24-trillion yen scale stimulus package was not enough to evoke a positive reaction from most investors. They will move to the yen and yen-denominated assets only after they see main economic indicators clearly improve. The important thing is not the announcements but the actual implementation. Investors still doubt the LDP's central role in formulating public policy toward the banking system because the LDP continues to delay any definitive solution to the banking crisis. Due to the government's lack of credibility, the markets will no longer react to what politicians say, or even to what they do, but will react instead to the results of their actions.

In the real economy, October's business fixed investment has been decreasing significantly, partly because of financial constraints and weakened housing investment, although public investment has bottomed out. Private consumption has not yet shown a recovery despite the special income tax reduction. Due to the weak demand, production has been reduced substantially. With the decline in expenditure and production, corporate profits are worsening rapidly. Furthermore, the employment and income conditions have deteriorated further as the unemployment rate marked a historical

high and the decline in employee income has accelerated. Under these circumstances, corporate sentiments of business conditions have worsened substantially and consumer sentiment has become cautious.

However, with the effects of the comprehensive economic stimulus package and the recent monetary easing, the deterioration of the economy is expected to moderate gradually toward the second half of fiscal 1998. Nevertheless, the economy is hardly expected to recover immediately, judging from the strong negative signs mentioned above and the financial constraints such as financial institutions' cautious attitudes toward lending.

Given this current background, the idea of a consumption tax cut at the 5% level is now being frequently presented. The financial markets' reaction to such a proposal would probably depend on whether such a cut would stimulate the economy or give it only a temporary boost; it would also depend on whether the proposal itself was viewed as a serious policy action or a short-term political maneuver. We think that a consumption tax cut would have only a transitory effect on the economy. Even if a cut were to spark a short-term spending boom, it probably wouldn't dispel the pervasive pessimism in the consumer sector of the economy. In some cases, in spite of the tax cut, the unique Japanese saving pattern may show an increase in private saving since people who retired or plan to retire account for a considerable portion of the total population.

The more ultimate answer is raising Japanese consumer confidence, which has been unstable since the bursting of the bubble economy which began at the end of the 1980s. For this purpose, Japan's policy-makers must not only adopt but implement an aggressive, yet realistic, policy program which boosts confidence in the economy and addresses the fundamental weaknesses in the financial system. 

"The more ultimate answer is raising Japanese consumer confidence . . . For this purpose, Japan's policy-makers must not only adopt but implement an aggressive, yet realistic, policy program."