

TIGHTENING BIAS IN THE U.S.

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The U.S.: Tightening Bias

The U.S. economy has been demonstrating a strong growth momentum with low inflationary pressure, but this general perception was shaken by the announcement of April's unexpectedly high CPI data, up by 0.7% from March.

The Fed, which has worried over inflationary pressure, adopted a tightening bias as Alan Greenspan sent a signal to block off the possible overheating of the market. The Fed will closely monitor the market situation; however, it is not likely that the Fed will raise interest rates in June. The reasons are as follows.

First, high inflation will not continue in the coming quarter. Although the NAPM index and new home sales are still strong, international oil prices, which have been rapidly rising, will be in a box range because the OPEC countries do not seem to be observing their own production quotas. Housing, energy, medical equipment and clothes were major factors behind the rise in April's CPI. However, housing, which accounts for 40% of the CPI structure, is expected to slow in the next quarter. Additionally, there is not much concern about the price pressures from wage inflation. Although labor market is still tight, the wage cost index rose by just 0.4% in the first quarter, and productivity increase was 3.0% in the same period.

Second, the stock market will experience a correction. Although we now look for the S&P 500 operating EPS for 1999 to rise by 7-8% to \$47.00-\$49, many valuation models demonstrate

that a few major firms' stocks included in the Dow Industrial Average have been overvalued by 15~20%. If the stock market is automatically corrected, the Fed does not need to induce a sharp decline with a rate hike.

Furthermore, the increasing trend in individual consumption has slowed for six consecutive months, even though the level of consumption has increased. The recent trend means that even without a tightened money supply, the soft-landing scenario desired by the Fed has been realized.

Japan: Long-term Growth Potential Strengthened?

Japan's economy has stopped deteriorating, but clear signs of a recovery have not been observed yet. Business fixed investment has been on a downward trend, and the recovery in private consumption continues to be weak on the whole. Meanwhile, housing investment has been recovering. Public works seem to be increasing rapidly with the large increase in orders in early spring. Reflecting such developments in total demand and continued progress in inventory adjustment, industrial production has stopped declining.

As for the outlook, with the progress in inventory adjustment gradually paving the way for a recovery in production, fiscal stimulus measures, monetary easing and loan guarantees have had a positive effect on the economy. Improvements in the financial environment are also expected to exert positive effects on the economy gradually.

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However, there is no conviction that the recent corporate restructuring will enhance the competitiveness of firms. If Japanese firms and financial institutions pursue aggressive restructuring measures, such as selling off non-core businesses or large-scale write-offs of non-performing loans, their medium and long term growth potential will be strengthened. But, as of now, the restructuring has been superficial. Although large firms have cut employment extensively, the dismissed workers have been absorbed into small and medium firms which are tied to large firms through the so-called “keiretsu” relationships. It means that there have not

been enough layoffs in the overall economy. Compared with the employment cut, the retrenchment of capital expenditure will be extensive—around 9% down y-o-y; however, this will still not be enough for price stability and a ROI (Return on Investment) increase. In conclusion, the current corporate restructuring in Japan can increase long-term profitability to some extent, but it is not sufficient for resolving the problems of overcapacity and surplus labor. Furthermore, policy makers worrying over the political implications of the social costs of restructuring may limit the scope of restructuring. Therefore, while the major economic indices will gradually recover from previous months' figures, it is doubtful that the recent recovery will help strengthen long-term growth potential. **VIP**