BLEAK SIGN FOR FURTHER RISE IN YEN

Sung-Soo Yang
(yangs@hri.co.kr)

Strong Yen?

The continued yen rally as of late has raised the sudden possibility that the yen may strengthen further to break the resistance line of ¥110 a dollar. In the background of the strong yen lie three reasons.

Frist, Japan's economy is showing some strong signs of recovery. First quarter's GDP was up by 1.9% y-o-y; this was particularly remarkable because Japan's economy has experienced severe contraction for six consecutive quarters. Second, the Fed changed its policy stance from a neutral bias to a tightening bias. Theoretically, the rate hike stimulates capital inflow to the country with the higher interest rate, hence inducing a stronger dollar. However, concerns over a rate hike could cause the U.S. stock market to become bearish and eventually lead to capital outflows from the U.S. into Japanese and European stocks, which have been undervalued compared to their market fundamentals. The NIKKEI index has already gone far above 17,500, which was regarded as an important signal of longer term growth momentum. This bullish sentiment is causing additional large-scale capital inflow and directly triggering the stronger yen. Third, the U.S. Treasury may abandon the high dollar policy stance which it has maintained for four years. The U.S. current account deficit has rapidly increased for the last five years, and it is forecast to exceed 260 billion dollars in 1999. Therefore, it is doubtful that the U.S. Treasury Department can keep its strong dollar policy, in light of the resulting huge current account deficit.

Further Rise in Yen Unlikely

Despite the above factors, the yen's recent rally will most likely not be sustained for long. First of all, despite the first quarter recovery, the Japan's second quarter GDP growth could revert to a minus. Last year the Japanese government injected about 60 trillion yen to boost the stagnated economy. It temporarily increased GDP; however, permanent effects to strengthen long-term growth potential through the recovery of domestic consumption have not yet materialized. Also, the unemployment rate has reached a post-war record high of 5.0%, mainly due to corporate and financial restructuring, which is still cooling consumer sentiment.

Second, even though the NIKKEI index is on the rise, if the major economic indices of the second quarter are weak again and the corporate earning prospects are corrected downward due to the yen's uptrend in June and July, it is doubtful that the recent yen rally will be sustained.

Third, there are concerns over a drastic downturn of the U.S. economy if the dollars becomes weak too fast. Since the U.S. stock market already seems in a correction process and the Fed is considering the rate hike, if the Treasury explicitly abandons the strong dollar, it could trigger a drastic decline in the stock market and ultimately obstruct the soft-landing of the U.S. economy. As a result, the yen will not be strengthened further, and turn back to the ¥120 per dollar level in the coming month. VIP