

CONCLUSION: JAPANESE RECOVERY SPELLS MAJOR SHIFT IN MIX OF FACTORS THAT FOSTERED “GOLDILOCKS ECONOMY”

A Japanese Business Cycle Upturn

Last month, ECRI finally predicted a Japanese business cycle upturn (*International Cyclical Outlook*, Vol. IV, No. 5, page 1). Two weeks later, on June 10, a rise in Japanese first quarter GDP caught most forecasters by surprise, and elicited widespread disbelief about the reality of the upturn.

ECRI's forecast of a Japanese recovery is based primarily on its Japanese Long Range Gauge (JLRG), which had correctly forecast the current Japanese recession in early 1997. The data are now showing a pronounced, pervasive and persistent advance in the JLRG, underpinned by two back-to-back quarters of rises in Japanese consumer expectations.

Moreover, a close look at shorter-leading Japanese leading indicators confirms the positive outlook: Not one of these indicators is still in a decline, while several show moderate to strong signs of an upturn.

Finally, several coincident indicators are also starting to turn up. Industrial production and wages have risen from last fall's lows, and even employment shows an uptick. The latest GDP figure just provides further confirmation of a Japanese business cycle upturn.

Thus, the key to our forecast is not that GDP rose in the first quarter, but that the cyclical indicators have been rising in the classic sequence that unfolds around business cycle upturns in all free market economies.

Key Ingredients of a Goldilocks Economy

The U.S. economy has enjoyed several years of non-inflationary growth, which has been made possible by a mixture of skill and luck. While the skillful handling of monetary policy in recent years has been widely recognized, a key ingredient of the not-too-hot, not-too-cold Goldilocks economy has been imported disinflation.

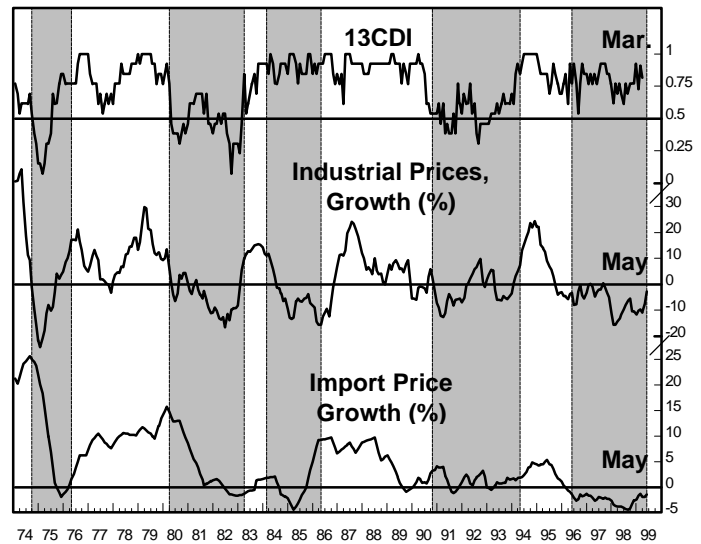
In the 1990's, there was virtually no sustained period when every major region of the globe was growing in sync. The decade started with an “English-speaking recession,” but the recoveries in these countries were followed by downturns in Europe and Japan. Not long after those economies recovered, Japan entered its latest recession, and the Asian crisis began. The Asian crisis has clearly ended, but Japan has remained the holdout – until now.

With that about to change, we are faced with the prospect of healthy growth in North America, Asian recoveries *including* Japan, and continuing expansions in Europe. For the first time in years, there is the possibility of a synchronized global expansion on the horizon.

A Leading Indicator of Inflation?

By soaking up global overcapacity, a sustained period of congruous international growth can alter the balance between supply and demand, and ultimately influence U.S. import prices. Chart 26 shows ECRI's 13-Country Current Diffusion Index (13CDI), which is at its maximum when all 13 economies monitored by ECRI are growing, and at its

Chart 26: Global Growth and U.S. Inflation



Shaded areas represent cyclical downturns in U.S. inflation.

minimum when none are.

The chart shows conformity between periods of concerted global growth and cyclical upturns in U.S. inflation. An early indication of an altered supply-demand balance comes from the growth rate of industrial materials prices, which has an even better correspondence with U.S. inflation cycles. The shift in international demand also affects growth in import prices, a direct measure of imported inflation.

The last two measures are included in ECRI's U.S. Future Inflation Gauge (USFIG) as indicators of imported price pressures. They are both already in cyclical uptrends, but are not yet as strong as they were, say, in 1994, the last time the global economy was growing in sync, and the Fed aggressively raised interest rates. A Japanese business cycle upturn at this time makes it much more likely that a period of synchronous global growth is on the horizon.

The Current Outlook

The U.S. economy is set for a period of healthy growth, with underlying inflationary pressures already in a gentle uptrend. Will the Japanese recovery substantially increase those pressures going forward?

That is not inevitable, especially if the U.S. economy slows next year. What a Japanese recovery will do, though, is potentially alter one of the key conditions that has allowed the U.S. to enjoy years of noninflationary growth.

Thus, it is critical now to monitor the JLRG, as well as the USFIG, which is likely to provide the earliest reliable reading of any sharp increase in inflationary pressures.

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