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Foreign Exchange Outlook – 4th August 2010

Special Focus: Is the USA the next Japan

Today we take a look at one of the longer term themes that have been on our minds over the last few months and that is the ongoing worry that the US economy is slowing turning into the next Japan.

To recap; the Japanese economy has struggled ever since the sharemarkets bubble burst in 1989. For the last 10-15 years Japan has experienced persistent deflation, falling consumption, rising Government debt, shrinking bank loans and zero short term interest rates. As deflation has become entrenched people have not wanted to borrow and instead have been happy to save and defer spending. This has led to an ongoing cycle of declining asset prices. To try and prop up the economy the Government has spent heavily, running up large budget deficits to such an extent that Government debt to GDP is now 215% (NZ's is approx 25%)

Looking now at the USA; we are starting to see the first signs of shrinking consumption, rising savings and falling prices at the retail level. Last week the Federal Reserve said it thought that it would take 5-6 years for the economy to recover. Does this mean that US short term rates will stay at the current 0.0-0.25% level for the next 5-6 years (very much like Japan)? The US Government is running a deficit this year of approx 9.0% of GDP which will take its overall deficit up to 85% of GDP. In the absence of real growth in the economy the Government is propping up the economy, as is the case in many western economies. The stock of loans outstanding in the US is falling as consumers and banks continue to retrench.

The US Authorities are very conscious of what has happened in Japan and are on the record as being prepared to do whatever they can to avoid the economy falling into the same type of malaise that has affected Japan for the last 10 years. Is the Japan disease avoidable for the US, or inevitable?

Japanese yields fell and did not recover, unable to stoke Japan from a deflationary malaise

