

Section 2

THE U.S. ECONOMY APPROACHING A SOFT LANDING: IMPLICATIONS FOR JAPAN AND THE GLOBAL ECONOMY

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1. Introduction

In March 2020, COVID-19 spread rapidly across the United States, resulting in the loss of many lives. The economy was in turmoil, and the unemployment rate was as high as 14.7% in April 2020. To cope with the emergency, the U.S. government and the Federal Reserve Board of Governors (FRB) immediately implemented bold expansionary fiscal and monetary policies, respectively, and continued them seamlessly thereafter. Some economists had warned from the beginning that these policies were too expansionary, and when added to other factors like the global rise in resource prices, the U.S. economy experienced severe inflation. To control the high inflation, the FRB has been rapidly tightening monetary policy since 2022. As a result, the U.S. economy has been steadily reducing the inflation rate while avoiding recession, and is on track for a soft landing at the 2% inflation target. However, since the summer of 2023, the inflation rate has remained high at around 3.5% for a little less than one year and has not been able to decrease further to date.

The first half of Section 2 describes the series of economic trends in the U.S., while the second half explains how the initial expansionary fiscal and monetary policies adopted by the U.S. government and the FRB, as well as the tight monetary policy adopted by the FRB after 2022, have spread to the global economy, including that of Japan. In particular, we will show that the influence of the U.S. economy remains extremely significant, despite some assertions that U.S. leadership in the world is declining.

The first two subsections, Subsections 2.2 and 2.3, respectively report on the activities of the U.S. goods and services markets and domestic financial markets. Subsections 2.4 and 2.5 respectively explain the impact of recent U.S. economic developments on the global economy and their impact on the Japanese economy. Finally, this section was written in November 2024, before Donald Trump had been elected to the U.S. presidency.

2. The Real Economy in the U.S.

The U.S. production level has remained almost flat since 2023 due to the monetary tightening by the FRB from the beginning of 2022. However, it has already exceeded the pre-COVID-19 pandemic production level in 2022. The unemployment rate after the pandemic, which had remained low due to the expansionary fiscal and monetary policies of the government and the FRB, has been on a slight upward trend since 2023, reaching 3.9% as of April 2024, which is still quite low. As shown in [Figure 1-2-1](#), the economic growth rate has remained steady at around 3% since the middle of 2023 and is quite solid.

The U.S. economy is now in the final phase of its soft landing from high inflation, and the FRB is examining both the economy and the inflation rate, while considering such economic indicators as the number of new workers, the unemployment rate, and various inflation indicators, in order to reduce inflation while avoiding an economic stall.

As [Figure 1-2-2](#) shows, the greatest current challenge for the U.S. is high inflation. The CPI inflation rate for the U.S. economy has been steadily declining since its peak of 9.1% in September 2022, thanks to the FRB's rapid monetary tightening starting in 2022, however it stopped in the mid-3% range in the summer of 2023 and has been slow to fall from there. As of March 2024, the CPI inflation rate was 3.5%, considerably higher than the 2% target, and the expected inflation rate has also remained high.

These are the recent trends in the real U.S. economy. Although the inflation rate has remained high in the 3% range and the timing of the soft landing to avoid recession has shifted back slightly, the economy as a whole is generally in

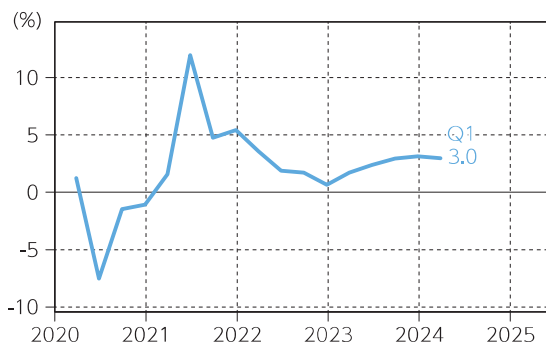


Figure 1-2-1 U.S. real GDP growth rate (YoY)

Source: Federal Reserve Bank of New York

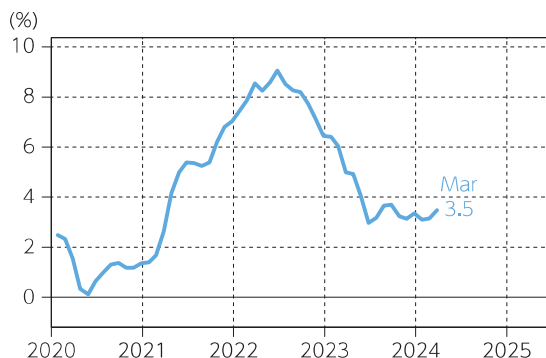


Figure 1-2-2 U.S. CPI inflation rate (YoY)

Source: Federal Reserve Bank of New York

a steady recovery process. In Subsection 2.3, we will examine the trends in the U.S. financial markets.

3. The U.S. Financial Markets

At least four factors should be considered in explaining the persistence of high inflation. First, the U.S. economy has always been strong (in terms of aggregate demand), even before the COVID-19 pandemic. Second, there was a global surge in resource prices. Third, the U.S. government and the FRB implemented bold expansionary fiscal and monetary policies to respectively cope with the COVID-19 recession. And fourth, high interest rates in the U.S. and the strong performance of U.S. companies brought investment money from the rest of the world into the U.S. in search of high returns.

The first two factors are obvious and will not be discussed further. Regarding the third expansionary fiscal policy, under the Biden administration Congress approved the “COVID-19 Stimulus Package” in March 2021, amounting to about USD 1.9 trillion. Since then, the Biden administration has continued to implement large-scale expansionary fiscal policies, including infrastructure development. Most recently, in April 2024, a foreign aid bill of about USD 95 billion targeting Ukraine, Israel, and Taiwan was approved by Congress and implemented. This aid package will mean about USD 95 billion in arms purchases by the government, increasing fiscal spending, stimulating the domestic economy, and raising inflation and interest rates.

The FRB also implemented a bold monetary easing policy to cope with the COVID-19-inspired recession. The FRB temporarily lowered the short-term

policy interest rate to 0% and sharply increased the monetary base (cash plus deposits at the central bank) to stimulate the economy. However, once high inflation became imminent, the FRB reversed course and tightened monetary policy rapidly from the beginning of 2022. Specifically, the FRB raised the short-term policy rate (Federal Funds Rate) from 0% to 5.25% ~ 5.5% for about 18 months until July 2023. In addition, the monetary base, which had expanded rapidly to counter the COVID-19 recession, has been reduced since June 2022 (a policy known as Quantitative Tightening (QT)). However, while more than two years has passed since this monetary tightening, the inflation rate has remained high.

In addition to inflationary pressures from the fiscal and other spending sides of the economy, at least two other inflationary pressures are currently at work from the monetary side. First, although QT is being implemented, a significant portion of the vast monetary base injected into the market in response to the COVID-19 recession still remains in the market. One of the reasons why the monetary base has not been removed as originally planned is the series of local bank failures that began with the failure of Silicon Valley Bank in March 2023. In 2023, five more financial institutions failed, and in 2024, yet another failed. The FRB has been acting as the central bank's "lender of last resort," providing large amounts of funds to financial institutions at risk in order to protect the deposits of the failed institutions. As the FRB supplied funds to the market to maintain the soundness of the financial system, the pace of monetary base reduction appears to have slowed, as shown in Figure 1-2-3. As a result, a large

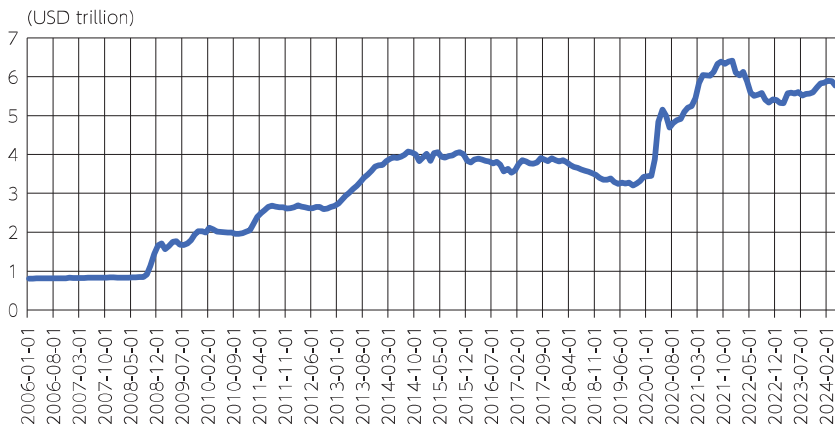


Figure 1-2-3

U.S. monetary base (January 2006 – April 2024)

Note: Not seasonally adjusted

Source: Federal Reserve Bank of St. Louis

amount of money still remains in the market, which seems to be an important contributor to high inflation.

Secondly, high interest rates and strong corporate performance in the U.S. are attracting investment money from around the world, and this may be another factor contributing to high inflationary pressure from the financial side. The FRB has tightened monetary policy since the beginning of 2022 to control inflation. As a result, the U.S. domestic interest rate has risen further, and money is flowing into the U.S. through interest rate arbitrage. Furthermore, the U.S. real economy has been strong despite the sluggish global economy. On the other hand, China's economy continues to slow due to a lack of spending and a slowdown in economic growth, partly because of a depressed real estate market and deteriorating local government finances. The EU economy is also in the doldrums, and global money is flowing into the U.S., which has a strong real economy. In other words, the high interest rates in the U.S. and the good performance of American companies are attracting money from around the world and bringing about a rise in stock prices and the dollar value. The inflow of money is thought to be stimulating investment (according to Tobin's q theory), promoting technological innovation, and contributing to the growth of the U.S. economy.

The FRB last raised its policy interest rate in July 2023. Almost a year has passed since then, and the FRB has also continued QT to this day. The fact is that inflation has remained high despite these two factors. The large amount of monetary base remaining in the market and the inflow of investment money from around the world would seem to explain part of the high inflation rate.

4. The Impact of the U.S. on Economies around the World

Developments in the U.S. economy have an impact on the world economy as a whole, roughly through the goods and services market channel and the financial market channel. In the goods and services markets, the U.S. economy is driving the world economy by expanding imports against the backdrop of a robust real economy. In the financial markets, on the other hand, the FRB has tightened monetary policy since 2022 to control high inflation, which has further raised the U.S. domestic interest rates and created a strong dollar value. The dollar's appreciation has spilled over to the rest of the world in the form of depreciation of other currencies. In Subsection 2.4, we explain how these trends in the U.S. economy spill over to the global economy through the goods and services markets and the financial markets.

(1) The U.S. Economy as a Driver of the Goods and Services Markets

In 2023, the economic growth rates of the global economy as a whole, including emerging economies, decreased.

While the European G7 economies suffered from a growth rate of less than 1%, the U.S. economy grew at 2.5% in 2023, the highest rate among the G7 nations. In this sense, the U.S. economy is leading the world economy as a whole through imports and direct investment in the goods and services markets, backed by its stable real economy. As shown in [Figure 1-2-4](#), the U.S. trade deficit increased rapidly from 2020, immediately after the spread of COVID-19, along with the expansion of U.S. policy measures against the COVID-19 recession.

In addition, in the financial markets, the FRB tightened monetary policy in 2022 due to the emergence of high inflation, which led to higher interest rates and a stronger U.S. dollar value in foreign exchange rates. As a result, the trade deficit in March 2022 exceeded USD 100 billion, the largest deficit since 1992, and the annual trade and current account deficits in 2022 were also extensive. Although the trade deficit has since been declining, it has remained high since 2023 and had not returned to the pre-COVID-19 pandemic level as of March 2024 ([Figure 1-2-4](#)). This suggests that the U.S. economy is still leading the rest of the world's economies in the goods and services markets through an increase in imports and the appreciation of the U.S. dollar value.

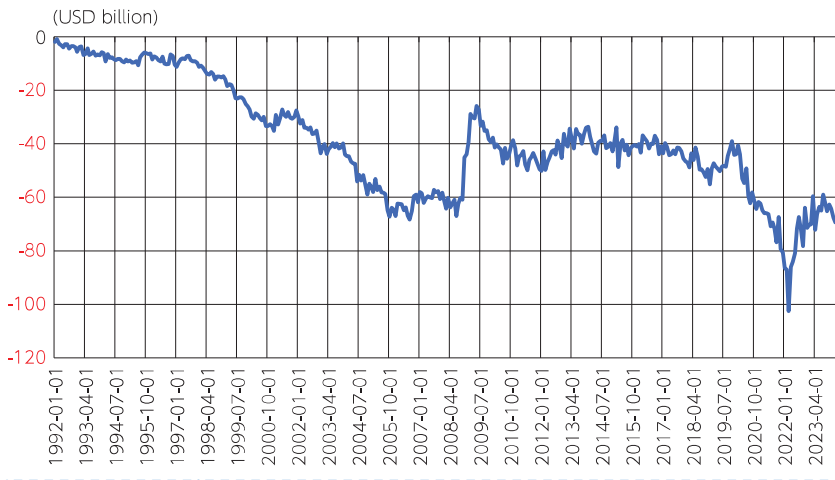


Figure 1-2-4

U.S. trade balance (January 1992 – March 2024)

Source: Federal Reserve Bank of St. Louis

(2) The Impact of High Interest Rates in the U.S.

[1] The Impact on spending in countries around the world

Since the U.S. dollar is the world's key currency, a rise in the U.S. interest rates affects the entire global financial market. The impact of a rise in the U.S. interest rates on the financial markets is transmitted through interest rate arbitrage between the U.S. interest rates and those of other currencies. To clarify where the problem lies, we will discuss two extreme examples of how national monetary authorities deal with a rise in the U.S. interest rate.

The first example is the case that the monetary authority in question takes no action to deal with a rise in the U.S. interest rates. In this case, interest rate arbitrage between the U.S. interest rates and the domestic interest rates of the country affects the domestic real economy in two ways. First, when interest rates in the U.S. rise, domestic interest rates also rise due to interest rate arbitrage. An increase in the domestic interest rates reduces or impedes residential investment, capital investment, etc. and as a result, total domestic spending is negatively affected.

The second path is through foreign exchange rates. As the interest rates on U.S. Treasury bonds rise, investors will increasingly sell domestic bonds and buy U.S. dollar bonds, and foreign exchange rates are expected to move toward a stronger dollar and weaker other currencies. The appreciation of the dollar and depreciation of other currencies will have a positive effect on gross domestic products as they are expected to increase in the aggregate.

It is difficult to determine a priori whether the negative effect of an increase in the domestic interest rates or the positive effect of a depreciation of foreign exchange rates will prevail since it depends on the country and the situation at the time.

This is what would have happened if the monetary authorities had taken no action.

In contrast, if the monetary authority intervenes in the domestic financial markets and leaves the domestic interest rates unchanged, what effect results? In this case, since the domestic interest rates remain unchanged, the only effect of an increase in the U.S. interest rates is through foreign exchange rates, which increases total expenditures.

[2] Responses of national monetary authorities and foreign exchange rates

In the previous discussion, we have only described the impact of a rise in the U.S. interest rates on the gross domestic expenditure of each country. In reality, however, the effects do not stop there. An increase in the U.S. interest rate creates

upward pressure on the foreign exchange rates of the U.S. dollar. A stronger U.S. dollar increases the balance of U.S. dollar-denominated foreign exchange reserves held by national governments, as well as their U.S. dollar-denominated debt balance. This is especially painful for countries with large amounts of outstanding debt balance, as it increases their real debt.

National monetary authorities should take measures to deal with a rise in the U.S. interest rates, considering not only the impact on each country's total expenditures, but also the impact on prices, asset prices, and government holdings of U.S. dollar-denominated foreign exchange reserves and outstanding U.S. dollar-denominated debt balance.

In addition, the degree of each country's financial system development will also determine countermeasures. The actual domestic interest rates and the foreign exchange rates against the U.S. dollar will differ depending on how each monetary authority deals with it. Which stance is best depends on the economic situation of each country.

Table 1-2-1 shows the average foreign exchange rates for several countries in 2021-23, clearly indicating the impact of the tight monetary policy taken by the U.S. from the beginning of 2022. First, the depreciation rates of each country's currency from 2021 to 2022 (figures in parentheses in 2022) show that each currency has depreciated against the U.S. dollar. This suggests that the depreciation of national currencies was not caused by the currencies themselves but by the appreciation of the U.S. dollar, due to the rise in the U.S. interest rates. In other words, the appreciation of the U.S. dollar is considered to have caused the depreciation of each currency.

Next, a comparison of the 2022 and 2023 columns shows that the eurozone and Thai currencies appreciated inversely from 2022 to 2023. These changes suggest that economic and currency factors in the euro area and Thailand affect

Table 1-2-1 Average exchange rates per USD 1 for each country

Country	Currency	2021	2022	2023
Japan	JPY	109.8	131.5 (19.8)	140.5 (21.9)
Canada	CAD	1.3	1.3 (3.7)	1.4 (7.7)
China	CNY	6.5	6.7 (4.3)	7.1 (9.7)
EU	EUR	0.8	1.0 (12.4)	0.9 (9.2)
Korea	KRW	1,144.9	1,291.7 (12.8)	1,306.7 (14.1)
Thailand	THB	32.0	35.0 (9.5)	34.8 (8.8)
Turkey	TRY	8.9	16.6 (86.1)	23.8 (167.5)

Note: The numbers in (*) indicate the depreciation rate (unit: %) of each country's currency from 2021.
Source: Internal Revenue Service, U.S. Government

their respective exchange rates.

With the exception of the Turkish new lira, the depreciation rates of the Japanese yen are significantly larger than those of the other countries in the table. This is a result of the Bank of Japan's policy of keeping the domestic interest rates low through its negative interest rate policy and Yield Curve Control (YCC) policy.

Turkey's net external debt is extremely large relative to its GDP. This may be the reason for the high depreciation rate of the Turkish New Lira.

Table 1-2-1 simply compares the exchange rates of the U.S. dollar in several countries (or regions), but since the exchange rates of each country are the basis of its economic competitiveness, they have a significant impact on each country's total expenditure with time lags. Subsection 2.5 illustrates this point using the Japanese economy as an example.

(3) The U.S. Hegemony and Trade Policy toward China^{1), 2)}

In addition to goods and services markets and the financial markets, the U.S. economy has a significant political impact on the world from a security perspective. The U.S. is said to hold hegemony (extremely strong power over competitors) in the following four areas: economy, currency, technology, and military power. The U.S. has special power in these four areas. The U.S. economy is the largest in the world, and the U.S. dollar is the world's key currency and the foundation for settling world trade transactions. The overall technological level of the United States is the most advanced in the world, and the U.S. military power is the strongest in the world. China has emerged as a threat to U.S. hegemony, especially after the year 2000. Following the Trump administration, the U.S. government has positioned China as a competitor that threatens U.S. hegemony.

Figure 1-2-5 shows the top three countries in terms of their shares of total U.S. trade (exports plus imports): Mexico, Canada, and China. As the figure shows, China's trade with the U.S. has expanded rapidly since it participated in the World Trade Organization (WTO) in 2001, and the Chinese economy has grown rapidly along with it.

After the Trump administration imposed high tariffs on goods imported from China in 2018, however, the global trade and FDI structure changed, partly

1) Sullivan (2023) provides a clear picture of the Biden administration's thinking on trade policy, including with China.

2) Due to space limitations, it is not possible to cover all aspects of the U.S. policy toward China, so the discussion in this subsection is limited to just one aspect of U.S.-China trade.

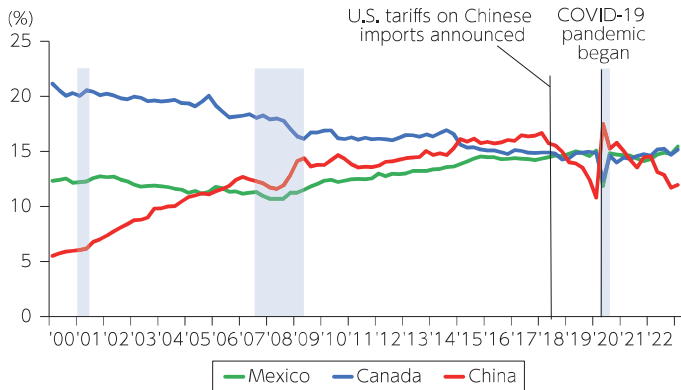


Figure 1-2-5

Shares of the top three U.S. trading partners

Source: Torres (2023)

due to supply chain disruptions and changes caused by the spread of COVID-19. In 2018, China's share of trade value was overtaken by Mexico and Canada to become the third-largest. In the first quarter of 2023, Mexico was in the top position.

The U.S.-China rivalry for hegemony that began with the Trump administration's U.S.-China trade friction has become even more harsh under the current Biden administration, which has expanded not only high tariff rates on imported goods but also export and investment restrictions in the high-tech sector, as well as demanding similar restrictions from U.S. allies.

Figure 1-2-6 shows quarterly data on total U.S. goods imports from China since 2017. The large drop in the center of Figure 1-2-6 is due to the rapid spread of COVID-19 throughout the United States. Observing the data since March 2020, after the rapid spread of the infectious disease, we can confirm that the import value has been declining slowly but steadily over the last two years. Imports decreased by 19.8% from January 2022, one year after the inauguration of President Biden, to January 2023, and by 2.8% from March 2023 to March 2024.

The extent to which the U.S.-China conflict has affected the two economies is not clear. Further investigation and research are needed to analyze the full extent of the impact.

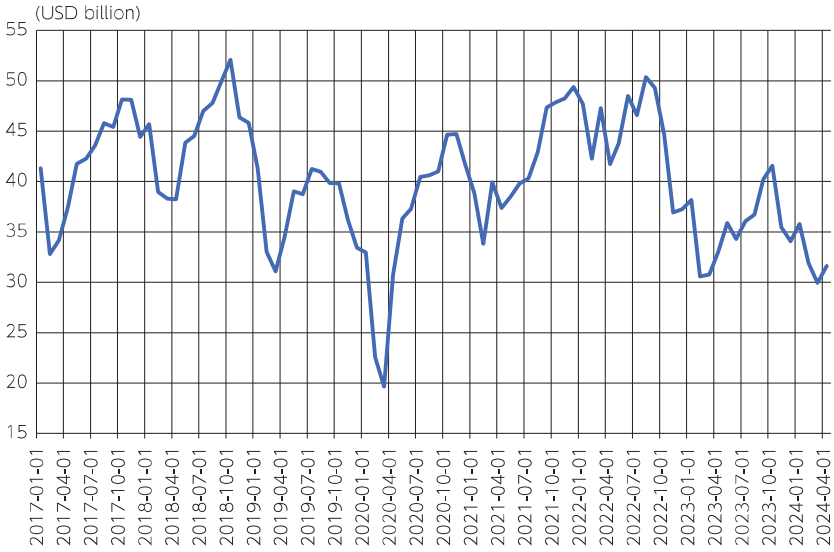


Figure 1-2-6 Total U.S. imports from China (January 2017 - April 2024)

Note: Not seasonally adjusted
Source: Federal Reserve Bank of St. Louis

5. The Impact of the U.S. Economy on the Japanese Economy

(1) Japan's Real Economy

The Japanese economy is currently benefiting from the U.S. economy in two ways. First, thanks to the robust U.S. economy, Japanese firms' exports to and direct investment in the U.S. are increasing rapidly. Second, the high interest rates originating in the U.S. have widened the interest rate differential between Japan and the U.S., and have caused the dollar to appreciate against the yen in foreign exchange rates. The depreciation of the yen, together with a time lag, has buoyed the Japanese economy.

The FRB began tightening monetary policy in early 2022, and since then, the dollar has appreciated against the yen rapidly. The depreciation of the yen pushed up domestic prices through an increase in the price of Japanese imports, which initially suppressed real consumption. In 2022, these effects were particularly noticeable, but in 2023, the depreciation of the yen improved the international competitiveness of Japanese products and services, leading to an increase in sales and profits for companies, particularly those in the export, food

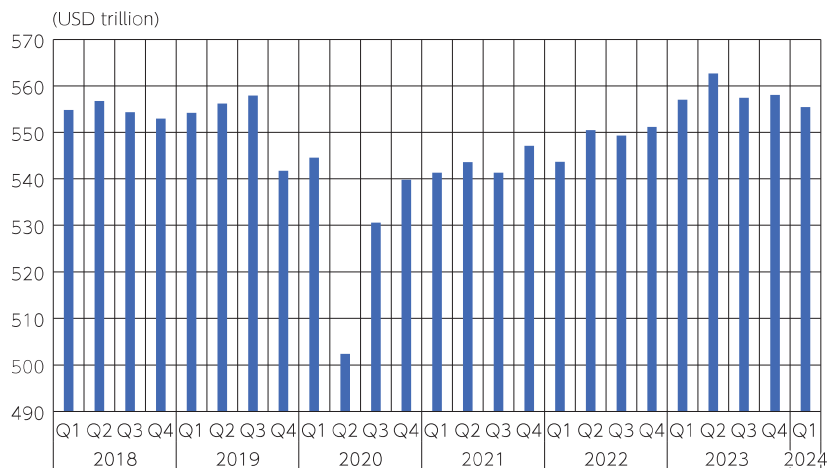


Figure 1-2-7 Japan's real GDP (Q1 2018 – Q1 2024)

Note: Not seasonally adjusted, Annualized rate
Source: Cabinet Office

service, and domestic accommodation industries, and a significant expansion in capital investment by major corporations. The standard “J-curve effect” in macroeconomics was at work, and the yen’s depreciation had an expansionary effect on overall GDP, centered on capital investment and net exports³⁾. Real GDP is now exceeding the level of 2019 before the COVID-19 pandemic. Figure 1-2-7 shows that the real GDP has been expanding since 2023.

(2) Monetary Policy in Japan

The impact of the U.S. on the Japanese economy is not limited to the real economy. It has also significantly changed the monetary policy that will determine the future of the Japanese economy.

The tightening of U.S. monetary policy since early 2022 has caused the U.S. long-term interest rates to rise, which has in turn exerted upward pressure on the Japanese interest rates through interest rate arbitrage. Since July 2023, the Bank of Japan’s (BOJ) YCC policy has clashed against this trend.

YCC is a policy to induce the yield on the 10-year JGB to stay within a certain range (e.g. $\pm 0.5\%$) above or below 0% by trading bonds in the market. For example, if the yield (or interest rate) is about to exceed 0% due to upward pressure on

3) For a more detailed explanation of the “J-curve effect,” see Honda (2022).

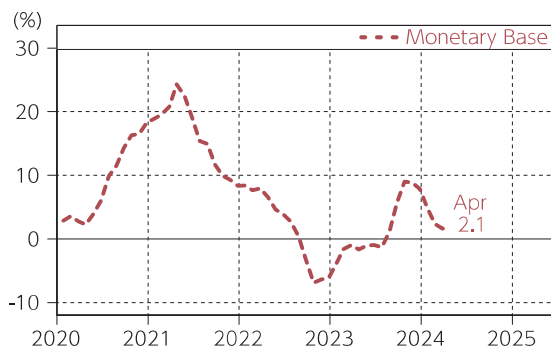


Figure 1-2-8

Japan's monetary base growth rate

Source: Federal Reserve Bank of New York

interest rates from the U.S., the BOJ will purchase an appropriate amount of the 10-year JGBs in the market to lower the yield and keep it within the target range (i.e. below 0.5%) (JGB purchases by the BOJ will raise JGB prices, which in turn will lower the yield on JGBs). As the BOJ purchases JGBs, the central bank currency (monetary base) paid for by the BOJ will be supplied to the private sector. The sharp increase in the monetary base growth rate in Figure 1-2-8 from July to December 2023 is a result of the BOJ's efforts to induce yields to its target. In other words, it is the result of the BOJ maintaining the YCC.

The increase in the monetary base will increase stock prices and appreciate foreign exchange rates, which are the respective prices of stocks and foreign assets (especially foreign currencies such as the U.S. dollar), which are substitute assets for the monetary base. From around the end of 2023, the price of Japanese stocks soared, and in February 2024, the highest price of 38,915 yen recorded at the end of 1989 was surpassed for the first time in 34 years. The foreign exchange rates also swung significantly in the direction of a weaker yen, and the yen-dollar rate began to hover around 150 yen to the dollar.

In general, asset prices, such as stock prices and foreign exchange rates, tend to fluctuate too much, often to the detriment of the goods and services markets. Many people are wary of sudden rises in stock prices and large swings in foreign exchange rates in the direction of the yen's depreciation, which they consider excessive. In fact, the Ministry of Finance intervened in the foreign exchange markets to a total of 9.7885 trillion yen between April 26 and May 29, 2024 "to deal with excessive fluctuations against the backdrop of speculative movements" (Finance Minister Shunichi Suzuki). With regard to the outlook for future prices, there is a clear downward trend in the inflation rate after peaking

Table 1-2-2

Major policy revisions at the BOJ's monetary policy meeting in March 2024

①	Elimination of the negative interest rate policy
②	Elimination of quantitative and qualitative monetary easing with long- and short-term interest rate operations (YCC)
③	Termination of new purchases of ETFs and J-REITs
④	Reduction in the amount of CP and corporate bonds purchases, etc., and termination after one year (approx.)

in February 2023, mainly in the goods market, while signals in the opposite direction are emerging in the labor market, such as labor shortages and wage increases in the information service, construction, medical and nursing care service, and transportation industries. Under these difficult circumstances, the BOJ made major policy revisions at its March 2024 policy meeting, as shown in Table 1-2-2. This policy modification was not only a shift toward tighter monetary policy but also a modification of the monetary policy framework itself, which had been in place since 2016.

There is a time lag in the impact of policy effects on the real economy. Long-term interest rates have already risen to 0.92% as of April 26, 2024, and from this starting point, policy effects are expected to gradually permeate the goods and services markets, including prices, production, and employment. As we have seen above, developments in the U.S. economy have an extremely large impact on the present and future of the Japanese economy.

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