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The world Economy in 2012

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1. Overhanging Clouds and Unclear Sky for the World Economy

The prospect of the world economy at the start of 2012 is not a bright one. Since the eruption of the global crisis in 2007, many economists have tried to forecast the time span for the normalization of the economy by measuring the depth and impact of the collapse of the bubble economy. But we are now entering the fifth year after start of the crisis. Certainly the levels of the production and consumer spending have considerably gone up from their bottoms reached in 2009, yet the sentiments of enterprises and households are far from being recovered. In fact there remains a strong concern that they may be involved in another financial crisis at any moment depending on the developments in the European sovereign problem. This is not only because they have not recovered from the blows they suffered in the past crisis, but also because the root cause of the crisis still remains unresolved with no appropriate addressing of it.

In the emerging economies, the outlook is brighter than that for the advanced countries, but they still hold fragile aspects especially in their political and social strains.

2. The Cause of the Euro Crisis is not in the Government Debts

The pressing greatest risk for the global economy now is probably the European sovereign debt problem. In early January, Standard and Poor's, a US rating agency, downgraded the credit ratings for 9 European countries including France. Although these actions were somewhat expected, they once again forced the Europe politicians to face a harsh reality that a delay in solving the problem may further deteriorate the situation. However, there is no one who can draw a clear plan for comprehensive measures to remedy the European malady. All that they are doing is they are desperately trying to do just what they can do, namely to implement the stopgap measures thus far agreed.

The problems of the Euro-zone can be classified into three layers of fundamental, secondary, and tertiary ones.

(1) The fundamental problem is the current account imbalances

The fundamental problem affecting the euro-zone lies not in the government debts but in the lack of the function to correct current-account imbalances among the euro-zone countries. Current-account balances reflect not only the relationship in the payments of trade of goods and services but also the relationship in the financial and investment flows that move from the surplus countries to the deficit countries. Generally, when the current-account deficit of a country grows too big, the overseas banks and investors start to have concerns against the value of its currency and refrain from their investment into that country. Thus the widening of the gap of the current account will be stopped at some point through the depreciation of the currency. However, as the imbalance of the current-account in the Euro-zone does not affect the currency value of the euro, both creditors (surplus countries) and debtors (deficit countries) have been indiscreet in building up their balance sheets.

(2) Sovereign debts are secondary problems

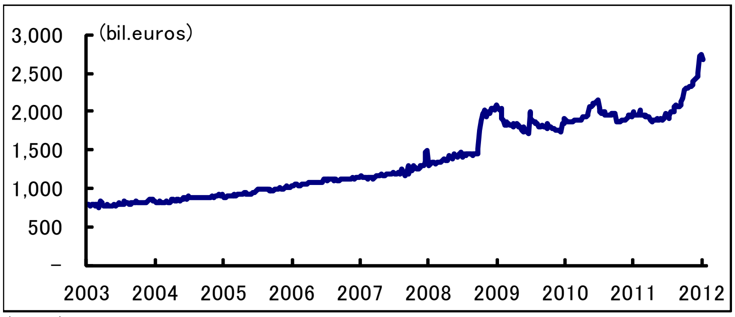
The secondary problem is the one that excess borrowings by the countries with current-account deficits are eventually concentrated in their public debts, which might develop into a sovereign crisis once they come to exceed a certain breaking point. This means that government debt problems are nothing but a result of the fundamental problems stated above. At an early stage of growing imbalances, enterprises and households will actively increase their borrowings and domestic demands will grow, thus raising the economic growth rates. Nothing seems to be wrong with this. When the economy falls into business downturn cycle, however, the more heavily dependent on the borrowing is the economy, the deeper the economic plunge will be and the more seriously the budget deficits will expand. In most cases, they are accompanied by the problems of increased non-performing loans of banks, which will result in further boosting, at least temporarily, the budget expenditures for recapitalization. In this way the debts will be centralized into the government sector and they may lead to a sovereign crisis.

(3) Most imminent strains on the financial market

The tertiary problem is that lowering of credit ratings of the government bonds could generate credit uncertainties among the European banks who are the main holders of these bonds. At present, the situation has not so worsened to trigger a financial crisis, but the credibility in the financial market is eroding and interbank markets are not functioning properly. Indeed this is the most pressing problem that is threatening on every day, at every hour. Regardless of their nationality, no banks can escape from the influence of this financial uncertainty if they have heavy loads of government bonds of European periphery countries, but the problems are by far serious and deeper to the banks in the periphery countries which hold a large amount of such government bonds.

The measures announced at the EU Summit in December 2011 include establishment of the ESM by one year ahead of schedule (slated for July 2012), provision of funds of E700 billion by the ESM/IMF, and adoption of stricter fiscal rules. What can be expected from these measures, however, is at most to avoid the sovereign crisis, the secondary problem. They are not satisfactorily addressing the fundamental problem, i.e. the current-account imbalances. Neither do they address directly the daily strains mounting in the financial market. The European authorities are nothing but relying on the liquidity provision by the ECB to the private banks.

Expanding balance sheet of the ECB through liquidity assistance



(Source) European Central Bank

3. Another Problem of the US Economy that lies behind the excess borrowing

(1) The real economy of the US is gradually recovering

The US economy is on a gradual recovery process, but its speed is too slow to create satisfactory number of jobs to the US citizens. The biggest reason for this slow recovery is the delay in the revival of real estate market which can be accounted for by the heavy selling pressures on houses both from households who are trying to reduce their debts and from the financial institutions who want to dispose of their collaterals. Any signs of recovery in the housing prices trigger large amounts of housing sales, pushing down the prices once again.

Certainly some indices such as for income and employment are showing a recovery, even if slow one, and with them the sense of excessiveness of debts is fading little by little. Since the banks are not mired in such serious problems of non-performing loans as to make them reluctant to extend new loans, time will take care of the sense of excessiveness without any additional supporting measures.

(2) Spreading income gaps

Along with the solution of debt problems, what the US authorities need to think back is why the US households were inclined to heavy borrowing. If there is any factor for it and if it continues to exist, the US will return to the economy dependent on the consumption supported by borrowing. This is another problem which should be addressed.

Looked in a longer time span since the end of the Second World War, the US society seems to have had a transformation since around 1980s. Until that time, wealth from economic growth was distributed widely among the middle classes, but after that the distribution inclined toward higher income class. The Gini Index, which shows the gap of income in the nation, clearly reveals the change. Until 1970s the US was a narrow-gapped society close to the present Western Europe, but the gap widened to the level of Russia and China by the early 1990s, and in the 2000s the US has become a country with wider income gap close to the Latin American countries.

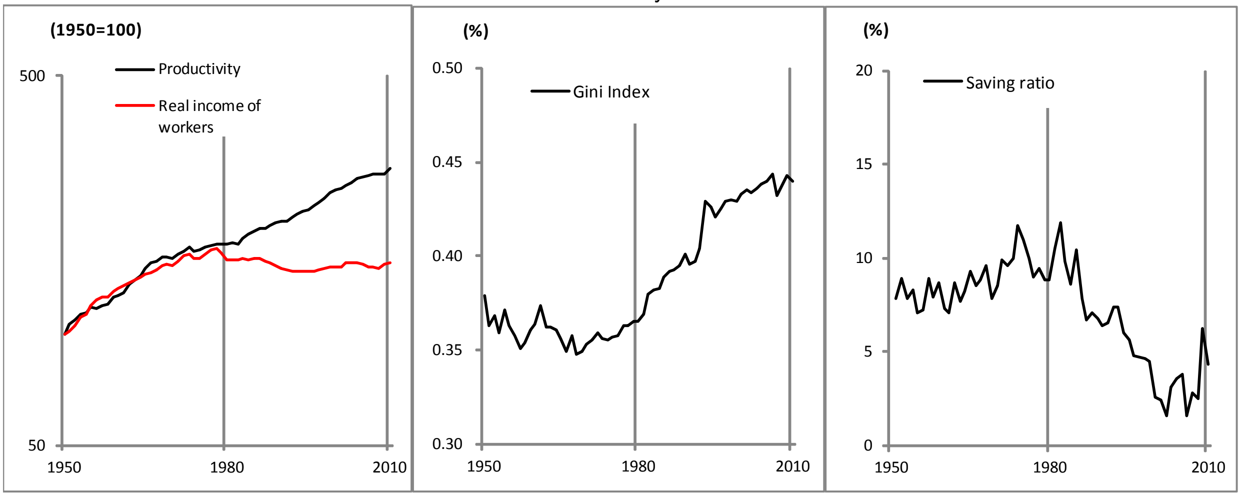
In any country the middle class plays a leading role in consumption, but in the US, the real income for the middle class has shown virtually no growth even in the rapid growth of the country as a whole.

Borrowing was the tempting means to narrow the income gap between their gains and what is considered to have been gained as result of economic growth in the whole country. US saving rates also began to follow a long downward trend in 1980 or so after they gradually rose since the end of the WW2. The US consumption culture reflected in our image that people are consuming more than gaining was created around this time.

There may be divided opinions on whether or not the incomes of the higher income brackets are unduly high since there are various ways to measure the income distribution. However, we are safe in saying that the rich people in the highest bracket can retain huge amount of income that cannot be consumed by themselves even after making huge donations. If so, wasn’t it better if the tax system was utilized to reduce the gap and distribute widely the fruit of growth to the middle class people? Such an initiative would have produced mass consumption not relying on borrowing and contributed to a more sustainable macro-economic growth. Then the US economy could have avoided as a whole to become such a highly leveraged society and could have utilized the new supply-side technologies produced by IT innovations for more sustainable economic growth.

It is true that the total economic performance will decline, as we see in the failure of socialism, if we pursue the even compensation regardless of productivity. The supply-side innovations have much to do with high compensation. However, it may be the time for the US to listen to the criticism that the US society has gone too much to the direction of larger disparity and have a national debate on what to do.

Post-war Transition of the US society seen in the economic indices



(Source) Bloomberg, U.S. Census Bureau

4. The Real Risks in the Emerging Economies are neither Inflation nor Bubble

(1) Receding inflation fears

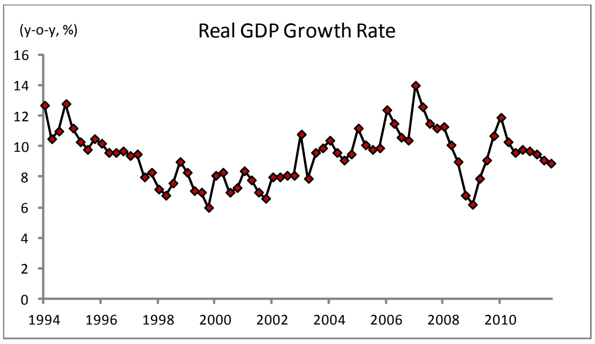
Economy in the emerging countries remains fundamentally strong. Common issue for these countries in 2011 was a concern of inflation. However, it is gradually fading as the prompt monetary tightening measures have worked successfully.

Since the Lehman's fall in 2008, many countries in the world applied heavy doses of fiscal and monetary stimuli and the emerging economies were no exceptions. Since they had more leeway in their budgets, they took more aggressive measures than the advanced countries. Furthermore, as they had no financial crisis domestically, the stimulus measures worked well to raise the economic growth rate. In 2010, inflationary risks mounted in many emerging countries and they turned to tighten monetary policies. More recently, however, some of them are shifting again to ease their monetary policies in an attempt to mitigate the negative influence by the economic slowdown in the advanced countries.

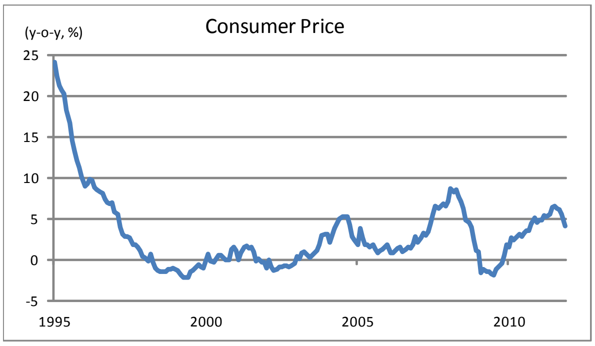
Emerging countries have experienced repeated cycle of expansion, tightening, and re-expansion in their macro-economic policies for last several years. Generally speaking, they were successful in taking such policy measures promptly and boldly. Especially, they were quick to address the inflationary concerns, bringing the early peak-out in inflation trend. This in turn enabled their easing of monetary policies.

In the future, some countries may experience real estate bubbles as an unfortunate implication of the current monetary easing. However, per capita GDP of such countries as the ASEANs, China and India that are leading the economic growth in emerging economies is still under 5000 dollars and these countries have possibility and capacity to grow in the future when the peoples can enjoy richer standard of living with active consumer confidence. Their purchases of housing and financial assets will also increase then. In this process, these countries may face times of economic overheating with possibility of asset bubbles, but even if the bubbles burst, they will have ample room to grow and are expected to overcome the damage with high nominal economic growth. At least at this stage, there may be no need to worry about these economic risks as a major cause for concern.

Chinese economy on a soft landing trend



(Source) Bloomberg



(Source) Bloomberg

(2) Social transformation in emerging countries that have spread from “Arab Spring”

Rather, we should pay more attention to the sustainability of present social and political system in the emerging countries. Least expected development in the emerging countries last year was what is called Arab Spring, a series of social revolution that started in the countries in North Africa and Middle East. It was a big surprise to the outside world that the revolution started from Tunisia. For, unlike Libya and Syria there was no image of an authoritarian nation for Tunisia. In fact, there is a strong impression for Tunisia that it is a country that has strong ties with the EU economies, a nation that receives throughout the year endless visitors from Europe to the site of Carthage or resort spots on the Mediterranean Sea, a nation that is closely connected with the prosperity of the global economy.

Not only Tunisia, but also other countries like Egypt, Morocco, and Bahrain that got contagion of the unrests had enjoyed increased loans and investments from advanced countries and expanded human exchanges with European countries. Many international conferences were held in Marrakech, Morocco, and Cairo in Egypt was the expected site for the Annual Meetings of the IMF and the World Bank this year. Therefore, it was an absolute astonishment to the rest of the world to know that there had been such a big accumulation of social discontent in these countries.

(3) Spread of unrest to Moscow at the year end

The same was with the demonstration by the people in Moscow that filled the Red Square at the end of 2011. The Putin government, although authoritarian, at least succeeded in restoring the Russian economy battered in the Yelsin days. Average life expectancy for Russian male dropped to mid-50 years at one time, but it recovered to over 60 years. This fact clearly shows that the levels of economy and social welfare have been improving. The recovery of the Russian economy was achieved through the effort to incorporate itself, making use of its rich resources, into the globalized economy that has enabled people, goods and capitals to flow frequently across the border. Based on his success of economic management, it was widely believed that the continuation of Putin's rule will contribute to the stabilization of Russia and for that reason the people are after all supporting for his continued reign. In that regard, it was beyond the scope of assumption of foreigners that the discontent of the people against the current administration came up to surface on the eve of the next presidential election.

The underlying dissatisfaction of citizens that appeared in the protests in Arab countries and Russia was not for the stagnant economy but for the negligence of social justice. Many emerging countries have joined the wave of globalization in 2000s, succeeding in raising their economic base that extends to the bottom of the pyramid. As long as the economy is heading for prosperity, little were addressed directly such problems as widening income gap that spread in a harsh competition, pervasive public corruption, and lack of social fairness. Among the emerging countries, Bulgaria and Romania have pursued both economic growth and social justice in recent years. Both countries tackled these problems because they are the requirements for EU accession. In this sense it is said that the framework and mechanism of the EU are contributing to the growth and stability of the European society in extremely wide ranges, which is the rare exception in the world.

5. Need to correct the course of the global economy

(1) Unquestionable benefits of the euro

As the euro currency system has its own difficulty and inconsistency which are easy to explain in a logical manner, it is subject to relentless attack from the outsiders when it meets difficult times. However, we should not forget about its benefits. Introduced in a big economic zone with the population of about 300 million, the common currency increased the transparency of the prices and enabled efficient mobility of economic resources throughout the single market. The scale of the market, affluent life and stability of the social system attract the young people from the neighboring countries of the EU, absorbing excellent human resources. As a result, productivity of the private sectors in the euro-zone as a whole has been increasing, while decreasing the fiscal burdens that are on the other side of the coin. Although its sovereign crisis is heavily focused, it should be remembered that the euro-zone's total fiscal position is better than that of Japan, the US, and the UK.

If we remember these merits, we can expect that the momentum will finally work to avoid at any cost the corruption scenario of the euro. The euro is not a symbol of fort that protects Europe from outside world but an "open gravity" that mobilize economic resources between the two. These are the actual accomplishments of the euro since its start. If the euro-zone countries enforce the Greeks to follow strict budgetary austerity ignoring the harsh reality of recession, and induce the withdrawal of Greece from the euro, it may be almost equal to the expulsion by other members even if it is its own choice. If that kind of development would happen, the constructive view given on the euro by the international society such as "peace" and "stability" would be surely transformed into "awe" and "fear".

(2) Compatible way for growth and justice

Perhaps, the message that we should receive from the problems evident in the US and emerging countries is that we should pay more attention to the aspect of economic and social fairness that has been long neglected in the globalization process of the world.

The globalization of the economy has surely intensified the competition among countries. In the advanced countries, export markets have been deprived of facing a threat of labour-incentive manufacturing of the developing countries and technological catching-up of the middle-income countries. Although they are posing a threat to the advanced countries, the middle-income countries cannot maintain satisfactory competitiveness without the support of government intervention in the exchange markets. Yet they cannot continue to rely on the lower currency policies as they are not only criticized by neighboring countries but also they are domestically faced with complains from the exporters that the nation as a whole has been burdened by the import inflation resulting from such policies.

Developing countries also face severe competition with other developing countries and have to worry about the situation that one successful business in a country will produce numerous competitors in others due to the low level of technology required.

Globalization forces any level of countries to incessantly create new values. In such an environment, you cannot afford to pursue domestic fairness. The first priority was to foster a champion company, otherwise you would be defeated in a global competition and the nation as a whole would sink. Aside from whether this was true or not, apparently the countries the world over were at least caught up in such obsession that was nurtured in a globalization.

The financial industries of the US were running at the top of such race. Since they stumbled in a subprime loan crisis in the US, and the European economy followed after in its faltering, spotlight is being cast throughout the world on the various economic and social disparities that have been so far ignored. People now start questioning if given rules, which they believed there was no choice but accept, are really impossible to replace.

The expected big wave in the years ahead would be the review of the current business models and social mechanism. For example, the Basel Ⅲ requirements and Dodd-Frank Act of the US are the new regulations that force the most globalized financial industry to make comprehensive modification of their business models. Of course this is not an sentimental expression like anger against injustice, but this is certainly a move to correct injustice in a larger context, and in a way has something in common with the extreme social movements like "Occupy Wall Street".

In the case of developing countries, backlash may not be confined to the change of business rules. In democratic nations, such discontents will be absorbed within the established political process such as parliamentary debate between parties or general election. However, changes will occur abruptly and discontinuously in a society that has no such mechanism. Arab Spring was the pioneer example for this.

Looking into the background of the Arab Spring which was triggered by the prosperity led by the globalization and dissatisfaction for the neglected social fairness in that prosperity combined with the lack of democratic political process enabling gradual adjustment, we will notice that China also has every factor of these. This year we will see changes in its leaders in major countries including Russia, the US, and China. What kind of choice the people will make through the election and what kind problems the Chinese top leaders consisting of limited number of "wise men" will set as priorities to tackle, these are the important events that will decide the direction of the world for the decades to come and surely we cannot take our eyes off their developments.

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