

Newsletter



Institute for International Monetary Affairs
(財)国際通貨研究所

Stable Development of the World Economy and the Roles of Japan and Australia¹

Toyoo Gyohden

President

Institute for International Monetary Affairs

The world economic landscape looks almost beautiful now. The US economy is still galloping ahead at a venerable growth rate of 3.5% p.a. Inflation is comfortably contained. Japan is recovering with a healthier financial sector and a more vibrant corporate sector. The recovery is supported largely by domestic private demand. EU is also showing promising upward signs. China, although slowing down a bit, is still growing rapidly. I was told that most Australians are quite comfortable with their economic situation now. It is most likely that the year 2005 will be remembered as one of the good years of the world economy.

However, one remarkable feature of today's situation is that the beautiful landscape is extending on top of an equally broad underneath filled with the sense of concern and uncertainty. The contrast between the bright and the dark is starker than that. The causes of concern and uncertainty are well known. I will talk about four major ones of them.

First, is the global imbalance. The most striking feature of the world economy today is that, while the growth of the world economy is so much dependent on the US growth to a degree we have not seen for many years, the imbalance within the US economy is simultaneously becoming serious. Since the US economy is eight times bigger than Chinese and two and half times bigger than Japanese, the 4% growth of the US economy is providing the aggregate demand equal to 40% of the total growth of the world economy as a whole. The US economy is serving as the single

¹ This article is a text of the keynote speech at the 43rd Japan-Australia Joint Business Conference held on the 11th - 13th September 2005 in Nagoya.

most important engine of growth. In the US economy, however, there are ominous signs of looming risks such as the ballooning current account deficit and the inflated asset market bubble, which is on the verge of collapse. The quagmire of Iraq, soaring gasoline price, and Katrina disaster are adding dark brush on the backdrop. The most troublesome imbalance is, of course, the current account deficit, which is almost 7% of the GDP. The intractable dilemma for the world economy is the fact that this current account deficit is the direct result of the insatiable consumption of American household. The almost explosive increase of US current account deficit during the last decade was mostly due to the increase of imports and 80% of which was attributable to the all sorts of consumer goods both durable and non-durable. The serious background of this situation is that there is no longer a strong industrial base in the US to produce such consumer goods. In other words, the nature of the US current account deficit today is, to a large extent, structural. That means, the effect of the price change, which can be induced by the dollar depreciation cannot be meaningful unless the size of the depreciation is very substantial. Or, the current account deficit could be reduced only by the contraction of the consumption. The US household savings ratios used to be around 10% during the '80's. It plummeted to almost zero now. The recovery of the savings ratio to, say, 6%, which is the historical average will imply a sharp slow down of the growth because the household consumption comprises 70% of GDP. Also, the US current account deficit is financed by foreign investment which aggravates the US net debtor position to the rest of the world. It will increase the burden of debt servicing and will, over time, undermine the confidence in the dollar. The decline of foreign investment will push up the dollar's long-term interest rate, which will precipitate the collapse of the asset market bubble. It seems to be unavoidable that if the precarious situation progresses further, it will heighten the concern about a sharp fall of the dollar and a sharp rise of the long-term interest rate. It is true that there are still many people, particularly among Americans including respectable academics and policy makers, who believe the situation is sustainable, but I am deeply concerned that the increase of the US current account deficit cannot continue indefinitely without smashing the confidence of the global market eventually. In other words, the seemingly comfortable world economy is actually sitting atop a house of cards.

Second concern is about the extraordinary expansion of the global financial market and its fluidity. As the result of the enormous international payment imbalance, worldwide easy monetary policy, and the phenomenal progress made in the financial engineering technology, the size of the global financial market has literally exploded during the last decade. The total amount of financial asset in the world today is almost \$250 trillion, five times of the world GDP, and 90% of which is made up by various types of financial derivatives. In addition to the sheer size of the market, the rapid process of globalization enhanced the fluidity of the market greatly. Billions of dollars of money can travel across the world in a matter of seconds. All of us are familiar with the argument

about merits and demerits of globalization. I recall I talk about the subject four years ago at this gathering. In my view, one clear advantage of globalization is that, at least in the private corporate sector and the government sector, there is a strong recognition of the importance of transparency and accountability in their governance. No leadership can claim its legitimacy without complying with the public requirement of transparency and accountability. The failure to do so will immediately provoke criticism and punishment. However, in the world of the financial market there is no strong requirement of transparency and accountability. Many pundits still argue that the expansion of size and fluidity of the market and the accompanying development of hedging techniques will, in a long-run, enforce the flexibility and the stability of the market. Hence, the freedom of act is still considered to be the fundamental principle, which should govern the market. In other words, lacking the world central bank, there is nobody who is truly responsible for the act of the market. Certainly, the world economy is benefiting from the extraordinary development of the financial market. Huge amount of wealth and employment was created. However, at the same time, the world has become increasingly wary of the inherent capriciousness of the monstrous creature.

Third concern is the geo-political risk which is now focused on Iran, Iraq, North Korea and the international terrorism. Fourth concern is the price of oil. I am not going to dwell upon these risks because I am sure most of you are more knowledgeable than I am and I have not much to add.

In sum, the world economic situation today is generally favourable. We are certainly enjoying it. There are uncertainties and concerns, but that is not a unique situation of today. In any period of good economic performance there were always some sources of concern. As I mentioned at the outset, however, what is unique in today's situation is that the contrast between the bright surface and the dark underneath is sharper than in the past. Also, what worries me most is that while it is not likely that the bright surface will get brighter anymore, the risks contained in the dark underside are getting steadily more serious. The crucial question is how long the precarious balance could be maintained. When the dark underneath has overwhelmed the bright surface, the market will have to respond. The extent and the nature of the response is, at the best, totally unpredictable. I believe, the world should try its best to avoid the hard-landing scenario. If we remain complacent for too long, the adjustment of the distorted situation will inevitably take a violent form, which will severely damage the stability of the global economic and political situation. Thus, we should better start the process of adjustment before it gets too late in a gradual but well-targeted fashion. It will be a tough job, which requires strong sense of cooperation and firm determination on the part of the major economies led by the US. The only thing I can say at this moment is "Let's keep our fingers crossed!"

Now I would like to talk about Japanese situation briefly. At last, the Japanese economy,

after more than a decade of doldrums, has started to recover. A favourable combination of investment, consumption and exports has been leading the recovery. Deflationary pressure is gradually easing. Stock price has hit the four-year high. Property market is close to the bottom and in some prime locations the price has started to rebound. There are four major factors contributing to the recovery. First is the remarkable strengthening of the financial sector. The ratio of NPL to the total loan assets in major banks was close to 20% in the late 1990's. It is now reduced to less than 3%. The consolidation of the financial industry has made a remarkable progress. Fifteen years ago there were two dozens of big banks in Japan. Now most of them were merged in three major banking groups. Regulatory apparatus was also restructured with higher efficiency and stronger governance under the newly created Financial Services Agency (FSA) at the helm. The banking industry is now much leaner, healthier and more profitable than before.

Second is the major restructuring took place in the corporate sector. At the end of the bubble period many Japanese companies were loaded with excess capacity, excess debt, and excess employment. Thanks to the strenuous efforts many companies have succeeded in reducing the triple burdens and, as the result, strengthened the financial position and improved the profitability. Today, many of them are poised to revive their investment and employment. The improved prospect in the labor market is conducive to supporting the consumer confidence and the household consumption.

Third is the improved prospect of the future. The structural reforms which were initiated and implemented under Prime Minister Koizumi's leadership in various areas including the policy making process, deregulation, privatization, public finance, etc. have contributed to change the public mentality. Now business and households in general are favourably inclined to believe that structural reforms are something doable and beneficial. Although the political and the social clout of those who are desperate to cling on to their vested interest cannot be underestimated, the public sentiment as a whole is clearly in favour of the notion that structural reforms must continue. The outcome of yesterday's election has reconfirmed the fundamental trend moving in the country.

Fourth is the supportive external environment. As I mentioned earlier, the US economy is continuing its robust growth led by household consumption and capital investment. Demand for imports remains strong. China continued a higher than 9% growth. The strong growth of exports to major markets contributed to the recovery of the Japanese economy.

As long as these favourable factors remain alive, I think we can be sanguine about the near to medium-term prospect. Needless to say, however, the near-term optimism cannot dispel the concern about the long-term future. As is well known, there are two major problems the Japanese

economy is faced with. First is demography. The birth rate in Japan is one of the lowest among industrial economies. In fact Japan's total population has peaked out and will start to decline soon. Because Japanese people tend to live longer, Japan will become the most aged society in the world. This is a serious challenge for the Japanese economy. With a shrinking member of the working-age population Japan needs to sustain a high rate of productivity increase in order to achieve even a modest growth of the economy. The aging society implies that a fewer working population has to support a growing retired population for its pension and health care. The situation will become not only financially but also socially and politically unsustainable. Japan is faced with a historic challenge to cope with. There are many areas where Japan can and should take effective measures. We need to delay the retirement and to arrest the decline of the working population by encouraging a greater participation of elderly, female and immigrant work force. Also we need to improve financial, social and legal environment so that young female population can be motivated to bear more children.

Japan's another long-term problem is its fiscal deterioration. As the result of the prodigal fiscal spending during the aftermath of the burst of bubble in the 1990's, Japan's public sector debt soared to 170% of its GDP. Annual debt servicing eats up 20% of the total expenditure. This is clearly an unsustainable situation. Japan has to go through a long period of fiscal consolidation. The government is trying to restore a primary balance of its budget in about ten years time. Obviously, the success will depend upon the determination and the tenacious efforts on the part of the government supported by the voters' cooperation. On the issue of the public debt, however, there are some comforting news. More than 95% of the debt is held by Japanese nationals mostly by government agencies and financial institutions, and all debts are denominated in the national currency. To that extent, the nature of Japan's public debt is different from the situation in some other countries. Nevertheless, with the prospect of a modest growth and a declining population the consolidation of the fiscal situation is indeed an issue of the high priority.

In sum, while Japanese economy is now on a broadly-based track of recovery, its long-term challenges are daunting. It is quite understandable that many people in the world today tend to view the future of Japan with considerable amount of concern and even pessimism, particularly in comparison with other Asian countries such as China and India. Apparently, these countries are catching up with Japan driven by extraordinary dynamism and strong aspiration to develop. Many people anticipate that by the middle of the century Japan will no longer be the singular economic leader of Asia. It may well be the case. After all, the global leadership role of a country will be defined by the aggregate of various powers which the country can exercise. The total power includes not only economic but also military, diplomatic, technology, culture and ideology. In that sense, Japan is certainly not in a position to claim to become a hegemonic power

like the US today. Indeed, we need to recognize that Japan is a country with so many vulnerabilities, which only few other countries share to the same extent. Japan is the most poorly endowed in terms of energy, food and natural resources. Japan depends 100% on imports for its oil supply. Self-sufficiency ratio of food is the lowest at 40%. Japan is the most vulnerable to natural disasters such as earthquakes and typhoons. Japan experienced the worst case of environmental deterioration such as the mercury contamination in the '70's. Japan has been suffering from the longest period of deflation. Japan is burdened with the worst case of fiscal impasse. Japan is experiencing the most rapid pace of the aging of society. And, of course, Japan is the only country, which suffered a nuclear attack.

When you go through the long list of woes befallen upon Japan, you may conclude that this country has nothing but a gloomy future. Nevertheless, it is also true that so far Japan has somehow survived all these woes with certain luck and much of strenuous efforts. Furthermore, Japan should be proud of some of the successes it achieved in coping with problems. Japanese economy's energy efficiency is the highest. Its emission ratio of CO₂, sulphur oxides and nitrogen oxides is the lowest. It has developed state-of-art technology in many areas of manufacturing, bio-chemistry and nano-science. It has carried out important structural reforms in spite of the deflationary pressure. It has preserved and developed much of its cultural heritage.

I would argue, in the final analysis, the viability of a country depends very much on its ability to adapt itself to the changing environment and its ability to implement necessary steps of self-correction. I strongly hope that Japan will continue to proceed on that path.

Now, in the final part of my presentation, let me talk about Asia-Pacific, which include Australia and Japan. As you are well aware, there has been a growing attention being focused in recent years on the issue of Asian integration. Since there are so much works and talks done on the subject I will not dwell upon the preliminaries but will try to tell you what is actually happening. If I describe the situation in one sentence, it will be: "functional integration is progressing, but institutional integration isn't". It is indeed remarkable that without much fanfare the intra-regional trade and investment in East Asia has reached the level tantamount to that of NAFTA and EU. And I have to stress that the most important aspect of the development is that an integrated production network has been established within the region. That is to say, East Asia as a region has become a huge single factory where parts and components are supplied by countries like Japan, Korea, and Taiwan and assembled in countries like China, Thailand, Vietnam and Indonesia. The creation of this Asian factory is, in my view, one of the most important phenomenon in the history of the world economy. The structure of the division of labor and the autonomous supply chain has boosted the intra-regional flow of all sorts of economic resources. The Asian factory is already playing a

decisive role in the global economy and its implication to the world is quite far-reaching. It has changed the role of the US, and to a lesser extent that of EU. Although many US and European companies are operating in East Asia, as national economies neither US nor Europe constitutes integral component of the Asian factory. Their function is the final buyer of the products made in the factory. This is an important factor, which made the US current account deficit more structural in nature. Australia's position is different. While Australia is not an integral part of the manufacturing process in the factory, it plays an important role as a major supplier of energy and raw material to the factory. Its interdependent relation with the factory has been strengthened.

Contrary to the progress made in the functional integration, the progress of institutional integration in the region has been lagging behind particularly in areas where political and security factors play a role. Indeed, the network of bilateral arrangements such as FTA or Central Bank Swap Arrangement is flourishing and the new format of ASEAN + 3 is becoming visible. Real multilateral institution in the region which incorporate substantive transfer of sovereign authority and the binding obligation is yet to come. The situation is in sharp contrast with EU. Reasons are not difficult to find. First of all, the diversity in the region is still deep and wide. Secondly, there is still a serious lack of political leadership to forge ahead to the integration overriding the conflict of national interest. Thirdly, the region is lacking a stable balance of power structure. The instability is obviously stemming from China-Japan relationship and China-US relationship. In other words, the region is still unable to assess and define the China's role in a mutually agreed way. Today, all Asians do not hesitate to acknowledge China's ascent as a global power. It is a historic reality no one can deny. China should be proud of its achievement so far. At the same time, it is also true that there is a considerable anxiety among many Asians about the future of China. They are wondering whether or not China is going to assert a hegemonic role in the region. They are wondering whether or not China is coming to share the common value with them.

When we look back 4,000 years history of China, we find there were about a dozen dynasties, which rose and fell. Interesting thing is that the life span of most of the dynasties falls within the range of 300-400 years. There may be a kind of biological calendar built in the body of empire. During the first 150-200 years the empire was born, grew and prospered to reach the peak of its glory. After staying at the height of a plateau for a while, it starts to decline and finally disintegrate. If we assume the present Chinese empire was born around the time of Opium War in 1840, we see the Empire approaching the apex of its power, and it will stay there for another several decades before it starts a process of decline and disintegration. I have to admit that I am telling you the story half jokingly and half seriously. It is entirely up to you whether you believe this hypothesis or not. We should also know that all Chinese empires were at their best, when the country was ruled by enlightened, benevolent, and ruthless Emperor, the Child of Heaven. People

trusted him, revered him, and feared him. The Child of Heaven responded to the people's wish, and the Empire prospered. What I am trying to say is that we have to understand some fundamental differences between the Chinese value standard and the so-called Western value standard, which is in effect de facto American value standard. Many Americans believe rather naively that democracy is inevitable and the individual human right is sacrosanct. All I can say now is that we need to know that there are 1.3 billion people who do not agree to it. I am not predicting the clash of civilization but, if China continues its ascent, soon or later the US will be faced with a historic ideological challenge. So far, the US was victorious over fascism and communism, and is now engaged in a battle against Islamic Fundamentalism. For the time being, I think we can leave the matter in American hand and let them worry about it. For Japan and for Australia the issue is more of economic and geo-political nature. It seems certain that in the 21st century the global importance of the eastern part of the Eurasian continent will be significantly enhanced. There are three candidates of global power, i.e. China, Russia and India. It is difficult to predict the future of the trilateral relationship. China is now leaping as the top runner. India is following, but it has to establish its own developmental model. Russia is playing with its exceptional card as the supplier of energy and advanced weaponry. Anyway, cooperation and rivalry between three powers will make the eastern half of Eurasian continent the stage of the global power game. On the other hand, the US, a Pacific Empire, will remain as a major player in the Pacific Rim region. Under the circumstance as such, Japan and Australia need to recognize that they are situated between two spheres of influence. Of course the situations of two countries are not similar. Basically, however, both of us are bound to strengthen respective economic interdependence with Eurasian continent while keeping our heart tied with the Western democracy across the Pacific. In a sense our body and soul are split. The situation as much can be viewed as posing a serious challenge for both of us but at the same time, it can be viewed as providing us with a valuable strategic opportunity. While it is fashionable now to predict that the so-called BRICs countries, which include China, India and Russia, will dominate the world economy by simply extrapolating their current growth for another several decades. I have to argue that it is totally unrealistic. The problems these countries are faced with are gigantic. Just think of three major challenges, i.e. demography, energy and water, and environment. These countries cannot solve these problems without close international collaboration, transfer of advanced know-hows and technology, adequate soft and hard infrastructure, and necessary financing. These exercises will not stop at the boundary of economics. They have to be carried out with a close reference to social and political dialogue. I believe strongly that Japan and Australia as the only countries in the region with a truly democratic society and a matured market economy with advanced technology and infrastructure can and should provide their assistance and exert their influence jointly to help formulate a constructive and non-confrontational relationship between two spheres of influence.

There are several channels through which we can cooperate to attain the goal. In the multilateral area I strongly advocate to expand the framework of ASEAN + 3 to include Australia. As the result, Australia will join in studies and discussions currently taking place in various areas with the view to promote a closer integration of the Asian region. It is the first and the indispensable step for Australia to become a full-fledged player in the Asia-Pacific. On the bilateral front, Japan and Australia need to establish a bilateral forum participated by both government and private sector to conduct a constant and deepened dialogue between us aiming at forging a joint strategy to deal with the interaction of two spheres of interest and the fluid Asia-Pacific situation.

In conclusion, I would like to stress the heightened level of uncertainty and unpredictability in the Asia-Pacific region. Both Japan and Australia must establish a strong economic, social and political foundation of their own. At the same time, the joint effort to play a strategic and crucial role to command the situation seems to be highly desirable.

Copyright 2005 Institute for International Monetary Affairs (財団法人 国際通貨研究所)
All rights reserved. Except for brief quotations embodied in articles and reviews, no part of this publication may be reproduced in any form or by any means, including photocopy, without permission from the Institute for International Monetary Affairs.
Address: 3-2, Nihonbashi Hongokucho 1-chome, Chuo-ku, Tokyo 103-0021, Japan

Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422
〒103-0021 東京都中央区日本橋本石町 1-3-2
電話 : 03-3235-6934 (代) ファックス : 03-3231-5422
e-mail: admin@iima.or.jp
URL: <http://www.iima.or.jp>