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Three Notable Topics of the World Economy[1]

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This autumn's international financial meetings have seen relative tranquillity in the world economy except for some concerns for unfavourable implications caused by the highest ever prices of oil. However, under the apparent stability of the world economy, there is an unignorable undercurrent in the United States, despite the bright signs in China and Japan. Followings are what I have thought through the talks with the people I met in Washington.

1. Global Imbalance

The most striking feature of the world economy today is that, while the growth of the world economy is dependent on 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 the Chinese and two and a half times bigger than the Japanese, the 4% growth of the US economy is providing aggregate demand equal to 40% of the total growth of the world economy as a whole. The US economy is serving as the single 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 in Iraq, soaring gasoline price and Katrina disaster are further darkening the already gloomy scene.

The most troublesome imbalance is of course the current account deficit, which

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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 US households. The almost explosive increase of the US current account deficit during the last decade was mostly due to the increase of imports, 80% of which was attributable to 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 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 consumption. The US household saving ratios used to be around 10% during the '80s. It has plummeted to almost zero now. The recovery of the savings ratio to, say, 6%, which is the historical average, would imply a sharp slow down in growth because 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 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 this precarious situation gets worse, it will heighten the concern about a sharp fall of the dollar and a sharp rise of the long-term interest rate.

Despite these circumstances, a peculiar sense of relief and satisfaction concerning global imbalance permeated Washington during the IMF/World Bank Meetings this fall. It is true that no one denies that there is a problem. It is equally true that nobody rejects the premise that US households need to save more. But there was a distinct lack of urgency, an acceptance of the status quo without dealing with the issue in any concrete way.

Why does such a nonchalant view prevail? Those in charge and those aiming to be in charge in a government tend to emanate an air of optimism anyway, but there seem to be several concrete reasons buttressing this attitude. First, there is currently no concern for inflation and no one suffers from over-liquidity. The housing bubble is a concrete risk factor, but the Federal Reserve Board's chairman, Alan Greenspan, points out that in the case of the United States, there is real demand and allows for the fact that thanks partly to monetary relaxation, rising housing prices lead to an increase in disposable financial assets, which in turn supports consumption.[2] As regards the rising oil prices, Chairman Greenspan predicts that the supply-demand imbalance will aggravate further due to structural reasons and acknowledges that the market does not see high energy prices as temporary, but discounts them as an inflation factor. He concedes that if consumers continue to buy oil at high prices, this could lead to less consumption in other areas. However, even if consumption of gasoline decreases, he does not foresee much impact on overall consumption and predicts that the US economy will continue to show a strong performance.

The second reason is that there seems to be no possibility on the horizon of a crisis developing in the financial system where a systemic risk might materialize. There are counterparty risks as a result of the increase in hedge funds. But regulatory authorities are taking necessary precautionary measures and even if there were a failure, there is enough liquidity in the system to avoid a liquidity crunch. Hence the view that hedge funds themselves are risky is no longer widely shared. Looking at other areas, the premium in emerging markets is decreasing due in part to the growth in Asia. There are still a number of developing countries that badly need more capital injection into the financial system, and financial institutions in newly developing countries, such as those in Asia, are not fully up to scratch vis-à-vis governance and compliance. Efforts must be made to avoid a crisis developing from such shortcomings. There is also the need to improve efficiency in domestic financial markets and to increase liquidity. Theoretically, major risks still exist. But there is no real awareness that there is a risk somewhere. Even if there are interest mismatches and foreign exchange risks, awareness of risks that do not materialize in the conventional business of financial institutions is minimal.

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[2] Speech by Alan Greenspan, Chairman of the Federal Reserve Board to the American Bankers Association Annual Convention on September 26, 2005: “it is difficult to dismiss the conclusion that a significant amount of consumption is driven by capital gains on some combination of both stocks and residences, with the latter being financed predominantly by home equity extraction. If so, leaving aside the effect of equity prices on consumption, should mortgage interest rates rise or home affordability be further stretched, home turnover and mortgage refinancing cash-outs would decline as would equity extraction and, presumably, consumption expenditure growth. The personal saving rate, accordingly, would rise. Carrying the hypothesis further, imports of consumer goods would surely decline as would those imported intermediate products that support them. And one would assume that the US trade and current account deficits would shrink as well, all else being equal.” “Their economic effect will, to a large extent, depend on the flexibility inherent in our economy. In a highly flexible economy, such as the United States, shocks should be largely absorbed by changes in prices, interest rates, and exchange rates…” He also pointed out that “the behaviour of home prices varies widely across the nation.”

Thirdly, the environment, demographics and energy have now become more serious global issues, partly reflecting the stabilization of the financial situation as mentioned above. There are strong voices cheerleading for a successful Doha Round but even here, there is not enough momentum for manifest success. This is because there are hardly any trade barriers that member countries see as a real problem. Even if tariffs are not lowered and quotas are not abolished at the Round, goods will still move and money will still be available. Pascal Lamy, the new WTO president, expressed much the same sentiments, indicating that although remnants of the free market philosophy are still there, in the age of progressing globalization, there is a decreasing need to promote liberalization of markets in the old way. On the contrary, there are those, like the NPOs, that regard market liberalization as benefiting big corporations and that there is an increasing need for a disciplined trade system.

So the problem of imbalance could be serious if the financing of the US current account deficit is disrupted, but such a situation may not occur and in that case there is no problem on the basis of the argument that a current account deficit will inevitably be financed on capital account. Underneath this optimistic view, however, there is a widely shared serious concern that the increasing US current account deficit is not sustainable. As I have mentioned previously, if left undealt with for too long, adjustment will ultimately be excruciatingly painful and could seriously hinder global economic and political stability. Though measures must be applied swiftly, the structural nature of the current account deficit makes it extremely difficult to deal with in the short run. The question is, as US Treasury Secretary John Snow said, if the United States reins in its economy precipitously to restrain consumption in order to decrease its deficit, is there a country that can replace the US as importer of international goods? Hence, the G8 members stated in the summit communiqué that they acknowledge their “shared responsibility to sustain and maintain growth within our own economies”, and they agreed that they must all play their part “through rigorous action to address global imbalances and foster growth.” They stated that “concrete and credible actions” were necessary including “continued fiscal consolidation to increase national savings in the United States,” “further structural reforms in the European Union” and “further structural reforms, including fiscal consolidation, in Japan.” Such gradual but targeted measures must be pursued step by step.

There are arguments for the IMF to concentrate its efforts on macro-economic adjustments with the focus on surveillance. However, the IMF provides financing mainly to developing countries and developed countries in need of macro-economic adjustments are not the recipients of such financing. Also, the IMF's role in the international aid market is decreasing because the private sector is now providing a far more substantive amount of capital. The ongoing tough criticism of the IMF derives from the fact that since the end of the Bretton Woods system in the early 70s, there is nothing for the IMF to defend. The IMF has since become a financing agent and there is much overlap with the functions of the World Bank. During the Asian financial crisis, the IMF did make some contributions in rescuing the hard hit countries but most Asian countries have been coping with the crisis by utilizing their foreign exchange reserves.

2. China

There is an insistent call for China to apply a more flexible exchange rate for the yuan. The reform carried out in this July was small, but should be regarded as an important first step on a long road. Dr. Zhou Xiao Chuan, the governor of the Peoples Bank of China, saying that the exchange rate of the yuan was closely related to the savings-investment balance, emphasized that while there is currently an over-investment in China, the problem was the low consumption demand. He mentioned the necessity for lowering interest rates for savings accounts and adopting consumption inducing loans such as mortgage and consumer financing as well as the country's intent on dealing with the underdeveloped social welfare system. The inherent difficulties of the domestic industries had to be dealt with in order to change the foreign exchange regime, according to his account, and currency policy had to be coordinated with various other policies. US Treasury Secretary Snow acknowledged the efforts made by the Chinese government to some extent. Although he said he understood that China faced various constraints, he was quick to point out that if the fixed exchange rate had been maintained, there would have been an one way speculation, and furthermore, it would have been impossible to stop the US Congress passing some protectionist measures.

However, the international opinion is not satisfied with the revaluation in July as it was so miniscule, and the Chinese government surely understands that the yuan's problem is by no means over. It would be necessary to completely liberalize capital transactions in order to adopt a fully flexible exchange rate regime, but it could easily take another five to ten years before such changes could be made. In the intervening years, the strategy would be to gradually increase the acceptable fluctuation range under the basket peg system while rigorously building the necessary domestic structure by strengthening banks and government owned corporations and streamlining capital markets. The mid to long-term issues for China's currency policy are, first, management of its foreign currency reserve which amounts to $ 800 billion, and second, internationalization of the yuan. The government is likely to flexible in adjusting the mix of the reserved currencies with the international financial environment in view and to actively use the reserve for overseas investments, especially purchasing US companies. Such Chinese acquisitions will not simply be economic activities since the targeted companies will inevitably be those dealing in natural resources, energy and the most advanced technologies, and will be observed closely as they are negotiated in the larger context of the international political, military and diplomatic arenas. Concerning the second issue, China has two options. First is to make the yuan the key currency of Asia, and second, to work with Japan towards the financial integration of Asia and the creation of an Asian common currency. Japan needs to work consistently to encourage China towards the second choice.

3. Overseas Reaction to Koizumi Reforms

Recently, Japan has been viewed quite favourably overseas as reflected in the bullish stock market not foreseen at the beginning of the year. Let us review the background to this phenomenon.

It is still true that the overseas assessment of Japan is very volatile.

Until recently, there were deep-rooted misgivings about the Japanese financial system and an idée fixe that Japan cannot change anything. Demographics and the fiscal deficit continue to be serious problems. However, there is now a general perception that restructuring and strengthening of the financial system is making remarkable progress and, as the recent election seemed to indicate, Japan may well have changed. Reports before and after the election were quite dramatic and Prime Minister Koizumi's tactics and the result could have been like shock waves changing overseas opinions.

Ten years into the stagnant economy since the burst of the bubble, the Japanese had an acute sense of crisis that the country was unable to stop sliding down a slippery slope. That is when Mr Koizumi appeared on the stage as prime minister, and the significance of how he demonstrated that the Japanese can change their country cannot be overstated. The public was able to dream that perhaps it was possible to change the system where policies were made primarily by the Liberal Democrat legislators closely connected to special interests and where the bureaucracies were very much part of this system. This change of view was indeed a momentous phenomenon.

Now, for the Japanese, reform means changing the old Japanese ways both in household and business dealings. This means they have come to appreciate three elements; that it is necessary to change, that change is doable and that change pays off.

Behind such change of perception are various improvements in the economy. First is the remarkable strengthening of the financial sector. The ratio of non-performing loans (NPL) to the total loan assets in major banks was close to 20% in the late 1990s. It is now reduced to less than 3%. The consolidation of the financial industry has made remarkable progress. Fifteen years ago there were two-dozen big banks in Japan. Now most of them have merged into 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 that 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 strenuous efforts, many companies have succeeded in reducing this triple burden and, as a result, strengthened their financial position and improved profitability. Today, many of them are poised to revive their investment and employment. The improved prospect in the labour market is conducive to regaining consumer confidence and increasing household consumption.

Third is the improved prospect for the future. The structural reforms which have been 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 changing the public mentality.

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

However, there are short-term risks. First is the rising oil price, though Japan has become quite resilient to higher prices over the years. Second is the risk involved as financial policies are adjusted. Is a smooth transition possible? What would the impact of the decline of JGB prices be as long-term interest rates rise? The effect on small to medium sized financial institutions may not be negligible.

Is it doable to decrease the fiscal deficit in the mid to long-term? There will be implications for the macro-economic situation as necessary tax reforms are implemented. Demography is another burden for the economy. Japan's birth rate is one of the lowest among developed countries and its population will start to decline in the not-too-distant future. Sustaining high rates of productivity is critical even just to achieve reasonable growth as the work-age population declines. The country is aging rapidly and a decreasing number of workers has to support the pensions and health care of retirees. Such an imbalance will inevitably bring instability not only financially but also socially and politically. Some measures that should be taken are raising the retirement age and actively employing the elderly, women and immigrants. Improving the financial, social and legal environment is also essential.

Although there is much debate on where the Koizumi reform will lead, the prime minister himself has not provided an adequate answer. Officially, he only has another year in office, and extending his tenure, though possible, is unlikely, considering Mr. Koizumi's personality. Even if the postal reform bill is passed, it will take time before the details are finalized. Japan is faced with various other pressing issues such as the regional finances, pensions and consumption tax. How much reform can we expect in a year? And what will happen if the administration changes in a year?

As the four elements contributing to the recovery of the Japanese economy show, the reforms up until now have been, except for the injection of public money to pay for the non-performing loans, spontaneous efforts by the private sector without the support of macro-economic policies. At the same time, the reforms themselves did not contribute in any major way to business recovery.

Depending solely on the self-imposed efforts of the private sector is no longer viable. The government must secure flexible financial and fiscal policies as soon as possible and secure the capacity to cope with cyclical business fluctuations. In future reforms, it is also essential to expand private initiatives through privatization. Among the large scale governmental institutions, there are postal savings, road construction and state financial institutions, but the truth is, neither demand nor jobs have ever been created through genuine privatization in Japan. Deregulation in such fields as education, communication and medical treatment, on the other hand, has had considerable impact. These are the important aspects that should be considered in future structural reform and pursuing such changes will go a long way towards maintaining positive views on Japan overseas.

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