

# Newsletter



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## **How should Japan Cope with the Increasingly Murky Global Economy?<sup>1</sup>**

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Ever since last summer, the global economy is becoming murkier at an alarming pace. It is a far cry from the 2005-2006 period when most economies enjoyed stability and growth, and there was a sense of euphoria for this global prosperity, a rare phenomenon in the post-war world.

The downturn was, needless to say, prompted by the subprime mortgage crisis, a meltdown of American housing loan financing. In addition, the pessimistic outlook for the American economy and the future of the dollar has deepened, and a fear is setting in that the global economy is on a course to chaos. In this paper, I will describe the current American economic situation, the general trend of the global economy, then the challenges for the Japanese economy in that environment.

The American economy is, without doubt, in a serious state. There is an important distinction between the current subprime crisis and the economic crises of the past. The current crisis is an amalgamation of the chaos which erupted in the housing market, one of the key pillars of the American economy, and the confusion in the securitization market, which is the cutting edge of global financing.

The housing bubble, which had swelled since the beginning of this century, produced high-risk subprime loans amounting to 1.4 trillion dollars. Utilizing highly sophisticated financial technologies, such loans were processed, packaged, and split into securities which seemed safe with high returns, and sold extensively in huge quantities. When the

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<sup>1</sup> This paper was used by the author when appearing on the NHK program “Shiten Ronten (Viewpoints and Debating Points)” on January 22, 2008.

housing bubble burst in 2006, the risk of the subprime loans turning into non-performing loans suddenly became all too real. As an obvious outcome, the value of securities backed by subprime loans began to fall and the number of transactions dropped. All those involved in this process in any way -- those holding the securities, conducting transactions, providing credit ratings or guarantees, or providing funds to this market – were badly affected by the turn of events. Simply put, this is the gist of the subprime crisis.

The most serious concern now is that this crisis could spread, gradually contaminating the rest of the financial world. Because of the extent to which these financial products are processed and packaged, it is difficult to clarify how much risk the various mortgaged backed securities face from subprime loans. This means that all other securities and the financial institutions dealing in such securities are observed with suspicion, which leads to credit supply stagnation in the markets. There are already signs of anxiety in the markets for credit card loans, automobile loans and various regional bonds. Even some of the major banks became short of capital as a result of increased write off of non-performing loans and have been forced to raise huge amounts of funds from overseas sources.

The other serious concern is the blow to the real economy. The burst of the bubble has led to the drop in housing prices and the decrease in the construction of new houses and sales. This leads to a decrease in investment and employment. Social problems, such as an increase in the number of attachment of properties and foreclosures are being observed. Household consumption backed by the increase in the value of real estate is beginning to fall. Stock prices are continuing their descent. The Federal Reserve Bank and the government are implementing various policies such as easing monetary conditions and implementing tax reductions, but so far, to no avail.

The possibility of the American economy falling into recession this year has become very high. The paradox is that monetary relaxation and fiscal stimuli can cut both ways and could invite a depreciation of the dollar and inflation. The worst scenario is being hit simultaneously by inflation and depression, and the financial markets turning into chaos. With the presidential election coming up in the autumn, the trends the economy would show in the next several months would be extremely important.

Because of the dire situation of the American economy, a pessimistic view of American leadership in the global economy is on the rise. The fact that major American banks are running short of capital and are courting capital investment from Middle Eastern and Asian sovereign funds seems to epitomize the fall in the standing of the

American economy.

The American economy had supported the global economy through its lavish private consumption in the post world war era. But the cost of this role was the accumulation of huge external balance of payment deficits and the scattering of the dollar around the world. The countries that accumulated those dollars happily purchased US bonds, helping to recycle the dollar back to the United States. This has meant that although the United States has been a serious borrower with a huge deficit, it was able to control the global financial and monetary situations.

However, this would change once domestic consumption slowed down. The United States could no longer be said to be supporting the global economy. Once the overseas dollar holders begin not only to buy US bonds but invest in stocks of American corporations and assets such as non-US currencies, gold or oil, the influence of the United States would be compromised to an extensive degree.

However, the weakening of the American economy and the loss of the hegemonic standing of the dollar do not immediately bring benefits to the global economy. The passing of the hegemonic baton of the global economy to the United States from the British Empire at the beginning of the 20<sup>th</sup> century was conducted extremely smoothly. However, current conditions do not allow for such a smooth change of the key currency. No other entity or group, whether it is the European Union or the BRICs, has the capabilities or is prepared to take on the role of the United States. If there are no successors while the ability of the United States to lead falters, the risks of instability and confusion would only increase. There are only two ways to avoid this scenario.

First is to create a framework for international cooperation to sustain order in the global economy. The second is for the United States to reform the current economic structure of low household savings and excessive consumption, and to regain its leadership role. But neither can be achieved in the short time, which means that the global economy would have to stagger on burdened with mounting insecurity.

What should Japan do under these circumstances? There is no way of avoiding the American subprime crisis negatively affecting the Japanese economy in various ways. The American authorities have the responsibility to take the necessary measures promptly to avoid the spread of financial turmoil and economic downturn.

But we must not forget that the Japanese economy has other challenges besides the effects of the subprime crisis. It is handicapped by its shrinking and ageing population and national fiscal deficit, and if they are not dealt with, the economy would gradually contract. We would have to survive on past savings. If the Japanese public is determined

not to succumb to this predicament, then the country must revitalize its society and economy in some way.

The most needed and effective way is to encourage and open the doors to both foreign and domestic corporations and individuals that have the creativity and aspiration to enter markets in all areas. We cannot avoid having the strong and the weak, winners and losers as a result. But to impede new entrants for that reason would result in not lifting the minimum standard of the society as a whole.

It is the responsibility of the government to illustrate what options there are for the Japanese economy in the future. And it is the responsibility of the Japanese people to make the choice.

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