The Chicago Council on Global Affairs – Japan Economic Foundation Seminar

Shaping New Economic Agendas

November 16, 2011

Cochaired by
Mr. Noboru Hatakeyma, Chairman and CEO, Japan Economic Foundation
Mr. Michael Moskow, Vice Chairman and Senior Fellow on the Global Economy,
The Chicago Council on Global Affairs

Welcome and Introduction

Marshall M. Bouton: President, The Chicago Council on Global Affairs

Mr. Bouton welcomed participants to the seminar. He discussed this unique opportunity to bring together Japanese and U.S. economic thought leaders to discuss the prospects for economic recovery in the U.S., EU, and Japan; emerging market growth trends; and new sources for global economic growth.

Mr. Bouton quoted the Chinese proverb "may we live in interesting times" and noted that these will be historic times. He added that when the wheel of history takes a sharp turn, it happens more rapidly than we think or predict it will– the world is witnessing very important changes in the global economic and political order. The seminar discussions will provide an opportunity to assess priorities that can be considered for the G-8 and NATO Summits happening in Chicago in May 2012.

Mr. Bouton introduced Noboru Hatakeyama, Chairman of the Japan Economic Foundation (JEF) and Michael Moskow, Vice Chairman and Senior Fellow on the Global Economy at The Chicago Council on Global Affairs (CCGA), adding that "we are deeply fortunate to have with us two extraordinary individuals to guide our conversations today."

Noboru Hatakeyama: Chairman and CEO, Japan Economic Foundation

Mr. Hatakeyama expressed his sincere appreciation to the staff of The Chicago Council on Global Affairs, in particular Michael H. Moskow and Marshall M. Bouton, for their full support of the seminar. Mr. Hatakeyama added that Shinichi Saito, Executive Director for International Affairs with the Japan Economic Foundation, was also influential and decisive to the planning and execution of the seminar. Mr. Saito was ambassador to Nicaragua until last year and currently serves as a board member of the Japan Economic Foundation. Mr. Hatakeyama also expressed his heartfelt gratitude to all seminar speakers and panelists. He noted that JEF has a long-standing partnership with CCGA. Seven years ago, JEF and CCGA jointly organized a study regarding the rise of China and India.

Mr. Hatakeyama provided an overview of current challenges to global trade. Today, there are many challenges in the global economy. One big challenge is the infrastructure of global trade. The World Trade Organization (WTO) is changing.

The WTO has legislative and judicial functions. The judicial function will remain in the future. However, the legislative function is, at least for the time being, dead. Even if the WTO can make decisions on legislative issues, it will be encumbered by its large number of members (over 150 members to date).

Mr. Hatakeyama proposed the creation of a smaller core organization, representing both developing and developed countries. This organization would be the G-10 and there would be three issues that will be critically important to address in relation to trade policy:

1. global warming
2. state-owned companies
3. resources

Mr. Hatakeyama expressed the gratitude of the Japanese people to the global community for the aid given to Japan in the wake of the east Japan earthquake. Japan has received support from 163 countries, regions, and organizations around the world. The U.S. stands out. America sent an aircraft carrier and rescue teams consisting of more than 16,000 service members. Currently, the Japanese government has given priority to the post-earthquake recovery efforts, which will continue for at least 10 years. The Japanese people will never forget the kind support extended by the American people in their time of need.

Michael H. Moskow: Vice Chairman and Senior Fellow on the Global Economy, The Chicago Council on Global Affairs

Mr. Moskow noted that the hearts of Americans go out to those citizens who were injured or lost their lives during the terrible tragedy of the earthquake and tsunami.

Mr. Moskow explained the topics to be discussed during the seminar. He noted that the seminar would be divided into three working sessions focusing on developed countries, emerging market countries, and identifying new sources of growth. He advised participants that as they move through today's discussions, it is helpful to think about short- and long-term global market trends and related policy options.

The first topic for consideration today is: In the United States, Japan, and European Union, what measures can be taken in the short- and long-term to reduce debt, ease unemployment, and revive the sluggish economy? This question will also help frame discussions for the remainder of the day.

Taking stock of the current global economic situation, it is clear that the U.S. and other developed countries experienced a deep and unusual recession caused by a financial crisis. This type of recession is different than other recessions for the following reasons:

1. These recessions are deeper and longer.
2. Recoveries subsequent to these recessions are slow and sluggish.

This is the short-term problem. The long-term problem relates to the amount of sovereign government debt and private debt that exist. Are we living beyond our means? What can we realistically expect in terms of long-term growth rates? What is potential (trend) growth on a long-term basis?

The second topic of the seminar involves developing economies. Emerging markets grow faster than developed countries, specifically the BRICs, because they are at an earlier stage of development. They can have faster productivity growth, and we can expect that they can grow faster. The majority of global growth has come from emerging market countries - China being the largest. How long we expect these nations to continue growing at a rapid pace? China's annual GDP growth rate of 9 to 10% cannot continue to be sustained at this level.

The third session today will focus on new sources of growth. Trade is an important area to focus on, as is interstate policy coordination. Each country operates based on its own legislative mandate. When trying to get countries to cooperate, they must do so in a way that does not violate their own national mandates. Treasury ministers gather, as do central bankers, and heads of state. Each executive role operates within a nationally prescribed legislative mandate, which adds to the complexity of policy coordination.

Mr. Moskow concluded his remarks by welcoming everyone to begin the day's discussions.

Session I. Regaining Economic Growth in Developed Economies – The Situation and Outlook for the U.S., Japan, and the EU

Presentation: Japanese Perspective

Many researchers who study Japan tend to attribute Japanese problems to Japanese culture, which is not a valid analytical framework. The Japanese economy has been stagnating for a long time. The decade following 1990 was once called the lost decade. We are now finishing two lost decades. We need strong initiatives to avoid experiencing three lost decades. The U.S. and Europe may fall into the same problem as Japan.

If you compare the U.S., Europe, and Japan, the Japanese economy suffered the most after the global financial crisis. Japan saw the biggest drop in GDP in post-war history. Like other advanced economies, the Japanese economy is exposed to global problems. Economic activity declined again after the 2011 earthquake. If Europe causes a worldwide recession, Japan will once again suffer setbacks. Important steps need to be taken in Japan:

1. Easing monetary policy
2. Ensuring market liquidity
3. Implementing currency depreciation and fiscal intervention to rescue private institutions

The yen appreciated in the foreign exchange market, which poses a serious challenge for the Japanese economy—particularly for export-driven manufacturing firms.

Supporting European countries is important not only for their own sake, but also for the U.S. and Japan. Regulations are needed to prevent the future failure of financial institutions. In Japan, the debt situation is worse than Greece. But most Japanese government debt is sold within the domestic market, so the risks to the global economy are limited. Japan has been dealing with nonperforming loans, and the number of nonperforming loans housed within large financial institutions is now substantially reduced. Smaller banks still have nonperforming loans, and this is one reason is why local economies across Japan are stagnant.

In Japan, there is a large productivity gap by industry. The agriculture sector offers a prime example of low productivity. Farmers are protected by the government and do not face international competition, which must be changed. Steps to improve productivity might include increasing market competition to force structural reform. Implementation of the Trans-Pacific Partnership Agreement could promote such reform.

Finally, to focus on the national disaster in east Japan, some commentators are very optimistic about the post-earthquake economic outlook. But it is not simple. The area impacted by the quake was an underdeveloped area in Japan. It is not enough to simply restore economic conditions to the pre-disaster status quo. The economy was already in decline. A new starting point must be created for northeastern Japanese economies. If successfully implemented, structural reforms in those areas can be a successful case study for other regions in Japan.

The outlook for the Japanese economy is entirely dependent on whether or not structural economic reforms are implemented.

Presentation: U.S. Perspective

Global growth has been recovering from the Great Recession. The global outlook is now deteriorating quite rapidly, and we find ourselves, as Christine Lagarde would say, in a truly dangerous new phase of the recovery. Growth has weakened and become more uneven. Unless the European Central Bank (ECB) acts more aggressively to address the sovereign debt crisis, we will see another financial crisis that will trigger another recession. Preventing the realization of this scenario is the single most important short-term priority for decision makers.

Sources of vulnerability for short- and medium-term growth include:

1. The fiscal situation and political uncertainty in the United States
2. The European sovereign debt crisis

The current forecast for world output is 4% (which is being downgraded even further). Prospects are deteriorating as we speak. The EU downgraded its forecast, and the International Monetary Fund (IMF) has grown increasingly pessimistic. Everything has shifted downwards in recent months. According to IMF stress test estimates, the U.S. and euro area could slide back into recession, with output in 2012 more than 3 percent below October 2011 IMF projections. Japan would fall 1.5 percent below current IMF projections. Latin America would face higher risk premiums and lower commodity prices, which could drag output down almost 1 percent relative to baseline.

The cure to the problem must fit the disease. Are sovereign debt rates rising because countries are insolvent, or because there is a run on sovereign debt? Each country must be analyzed in order to determine whether it is facing debt or deficit challenges. Greece, for example, has significant debt and a high deficit. It is insolvent. Italy, however, has high debt but not a particularly high deficit. Italy is a low-growth country. It needs structural reform. It can pay its debt. It has a liquidity problem, not a solvency problem. The Italian government is actually running surpluses. Italy has $1.2 trillion of outstanding debt. If Italy defaults, it would be catastrophic for Europe and a nightmare for world financial markets.

There is a risk of contagion. Think, for example, about how a bank run might work. There is a possibility of a self-fulfilling equilibrium. Spain and France do not seem insolvent, but their debt is high. They are clearly susceptible to contagion and at the mercy of multiple equilibria.

What can be done? If the risk of contagion exists, the only possible way to deal with it is through the ECB. The ECB can instantly stop the contagion factor. They can scoop up sovereign debt on the cheap. What stands in the way of this happening? Ideas matter – some economists (particularly in Germany) think inflation is right around the corner. However, there is very little price pressure in developed economies right now.

What will happen to the U.S. and Japan if Europe implodes? There is a possibility of contagion to financial markets. Our investments in Europe would fall dramatically in value if Europe implodes. Monetary policy should not be constrained by inflationary fears. There is currently no empirical evidence to support the fears of inflation hawks. Inflation is not always around the corner ready to strike.

The immediate problem in the U.S is a fall in aggregate demand. It is not clear how much more the Federal Reserve can impact long-term rates. There are limits to what monetary policy can do, which leaves fiscal policy as the most promising tool.

If properly implemented, fiscal policy can have a big impact. Clever fiscal policy can mimic the effect of lower interest rates on aggregate demand. An example of this could be implementation of a consumption tax today that would increase over time. This would simultaneously tackle the recession and help address long-term debt challenges. If the tax is set to increase at a scheduled rate, consumers would have an incentive to spend more today.

Discussion

Participants discussed differences between Japan and Italy:

1. 95% of Japanese debt is owned by domestic investors. In contrast, more than 50% of Italian debt is owned by foreign investors.
2. Japan has a current account surplus. Italy does not.

Participants discussed the prospects for an economic renaissance in Japan. Some argued that a real restoration of the Japanese economy is doubtful. Additionally, the domestic investors that hold the majority of Japanese debt may easily switch to foreign bonds if their investments become unstable.

The government must address debt-to-GDP ratio as soon as possible. There is a need to balance between growth oriented fiscal policy and public confidence in the stability of fiscal policy. One participant noted that when a country like Japan is entering its third decade of stagnation, the word "recession" is no longer appropriate. The more accurate way to describe Japan would be as a slow-growing country.

In the United States, what portion of the unemployment rate is due to structural imbalances, and what portion is due to the standard effects of supply and demand? Some participants suggested that approximately 1% of unemployment is structural, which still leaves a lot of unemployed workers. Others noted that there are many people who are no longer looking for work or who are working part-time involuntarily. Thus, there is an aggregate demand problem.

Participants discussed options for taxation, including a carbon tax and national sales tax. A key consideration is the elasticity of demand in response to a particular tax. One participant noted that a carbon tax by definition needs to be phased in if implemented. It would also need to be harmonized across countries in order to prevent colluding companies or industries from moving operations across borders to avoid taxation. One panelist noted that although the U.S. has bandwidth to raise taxes to European levels, Europeans themselves face a higher hurdle because taxes are already very high. One participant stressed the importantce of thorough-introduction of consumption tax on internet trade to secure enough tax revenue.

In the U.S., how much tax revenue is needed to pay for the growth of entitlement spending over the long-term? The rate of growth of entitlement spending must slow. 18.5% of GDP is tax revenue, and 20.5% is government spending. While an intriguing idea, a consumption tax in the U.S. raises questions related to state taxation and the federal income tax.

One participant suggested that a consumption tax is an ideal policy for the U.S., Europe, and Japan. In the U.S., excessive consumption was the cause of its trade deficit, which is why a consumption tax is needed. Further, if the U.S. introduces a federal consumption tax, it will be very helpful for Japanese policy makers to see the U.S. doing something similar.

Another participant noted that Japan needs a higher rate of productivity growth than the United States in order to maintain the same growth rate. This is because population demographics in Japan are far different (there is a population decline in Japan). Domestic demand must increase, which is a very difficult path. If domestic demand does not grow, the Japanese economy will remain stagnant. Reconstruction after the earthquake will be funded in part through an income tax increase. The corporate tax is very high in Japan and needs to be lowered if firms are to become more competitive.

The question of immigration was raised in relation to Japanese population decline. One participant noted that immigration liberalization would just be a one-time solution. Real productivity growth means changing inefficient policies. This panelist cited the agricultural sector as an example. Other participants agreed that it is necessary to improve productivity in several sectors of the Japanese economy, including agriculture. There is also a larger debate happening in Japan regarding the proposed Trans-Pacific Partnership (TPP) multilateral trade agreement.

Participants discussed the role of the ECB in addressing the European crisis. One participant noted that the ECB should stand ready to buy all Italian and Spanish bonds. Fiscal austerity cannot be the only solution to escaping this crisis. Cutting spending in the short-run is difficult, especially at levels demanded by current circumstances.

Participants discussed the outlook for ECB reform and the role of Germany: Would the Germans endure a systemic collapse rather than see the ECB assume such a strong fiscal role? One participant noted that there is an institutionalist view of economics at the ECB. The euro area basically has a zero current account. If there is chaos in Europe, the German people will suffer immensely because their exports will collapse. Another participant noted that Germans have strong inflationary fears based on their history with hyperinflation during the Weimar Republic. Two German members of the ECB leadership, Juergen Stark and Axel Weber, have voiced their opposition to buying bonds.

Participants discussed developments in the European banking sector. One participant suggested that the ECB will need to back European banks just like Federal Reserve backed U.S. banks. Another noted that Europeans have not backed European banks, so these banks are undercapitalized. Banks do not want to raise capital because doing so will dilute shares. If Europe implodes, the world is almost certainly looking at a 2008-like scenario. It is difficult to predict how financial markets would react, but the shock to exports alone would send the U.S. into a double-dip recession.

Session II: Emerging Market Growth Prospects and Trends

Presentation: Japanese Perspective

Can China sustain its economic development this year and into 2012? The answer is yes and no. China's strong potential demand suggests that it can sustain its economic growth because it has:

1. High savings ratio – supports the investment ratio and then drives economic development
2. Large population (and sizeable domestic market) – supports strong demand
3. Strong competitiveness of basic manufacturing industries

Chinese policy makers need to take steps to overcome problems and to help stabilize growth:

1. Privatization of state-owned commercial banks and enterprises
2. Development of a competitive, market-oriented system
3. Downsizing of government and changing of economic structure

In the short-term, the Chinese property market is still in a bubble and inflation is still very serious. The government must reform the renminbi currency regime.

How can China's economic infrastructure be changed to propel growth? Manufacturing and services industries are still the main engines for Chinese growth. However, this is not sustainable. The services industry must be strengthened, and China must lower its dependence upon external trade.

How can the services industries (information technology, financial services, etc.) be strengthened? How can more employment opportunities be created? Some labor has shifted from agriculture to service industries.

How can inflation be kept down? Total inflation is actually not so high. However, food inflation is a very serious problem. The key government priority must be to control food prices. Last February, the Chinese government adjusted the composition of its CPI basket, lowering food from 34% to 32%. If the government had not made this adjustment, it is possible that the inflation rate would be slightly different. Real inflation rates in China are often higher than stated government rates.

Interest rate control is not enough. The Chinese central bank needs to liberalize the interest rate regime such that interest rate control can play the role of a price mechanism.

Since 2008, the Chinese government has worried about damage from prices, and it has relaxed control of bank lending, thereby expanding the money supply rapidly. This is the reason for the property market bubble. Lending by commercial banks since 2009 and 2010 has driven an increase in market liquidity. Most money flowed into the property market. Property prices continue to increase. How can property prices be controlled and concurrently avoid a hard landing? This is a problem. The possibility of a hard landing is still very high.

The Chinese government must do more to rebalance the international economy. Revaluing the renminbi is not the only way to do this. The government must liberalize its economy and open its doors to foreign goods and services. It must also improve efforts to deregulate and loosen government control. Lastly, the government must reform the Chinese political system and create a transparent market and economic system.

Presentation: U.S. Perspective

The most exciting story in the world economy has been in emerging markets like China, India, Brazil, and sub-saharan Africa. If recent trends are sustained, we will have by 2050 a global economic structure like we had in the year 1700. In 1700, Asia accounted for 58% of GDP, Europe only 25%. The 2050 Asian share of GDP could be over 50%.

With the rise of emerging nations, we are looking at a very profound change in the structure of the global economy. This constitutes a defining issue for the development of economic and foreign policy worldwide. A key factor has been the rise of China as a major player in global trade. China has overtaken Germany as the biggest exporter of tradable goods. Investment share of GDP in China is 49%, which is the highest rate of any country in modern recorded history.

The rise of China and India has had a spillover effect in other developing nations. China is the world's major consumer of commodities, including copper, aluminum, and iron ore. Due in part to China's emergence as a major commodity consumer, there has been a significant rise in global commodity prices. This has impacted market activity in countries where commodities are sourced.

Despite strong GDP growth in emerging markets, food prices remain a key challenge. Food prices are much more important for developing countries than advanced economies. India, Brazil, and China have raised interest rates numerous times in recent years. How rapidly can developing countries go into reverse and ease their monetary policies? In some countries, inflation is still a problem. India raised its interest rate as recently as October because its inflation rate is still 9%. China remains concerned about housing prices. Governments are not necessarily going to move quickly to ease monetary policy. However, emerging economies have the potential to maintain growth rates by easing monetary policy and lowering interest rates.

Europe buys a large share of exports from the developing world. The danger of euro area implosion is a drop in exports from developing economies. Another risk is a credit crunch. Share prices of European banks are very depressed, and it is very difficult for them to raise capital. These firms must therefore shrink their balance sheets and sell assets, which means that they will be lending less. This may lead to disaster.

The current situation with U.S. fiscal policy represents a grave danger to economic growth. There is risk of significant fiscal drag. Unemployment benefits and the payroll tax cut will expire in six weeks unless Congress and President Obama can agree to a further extension. In addition, Republicans have rejected any offer for infrastructure spending. However, congressional Republicans may not be able to risk allowing the payroll tax cuts to expire. Otherwise, the administration can say that Republicans imposed a $1,500 tax increase on the average American family.

Panel Discussion

Participants discussed constraints on growth that go beyond current problems with inflation and monetary policy. In India, for example, structural and policy problems will limit growth to the 7-8% range (instead of 8-10%) during the next few years. Additional challenges and barriers to growth in India include:

- Continuing infrastructure deficit (power, transport, airport, port, road)
- Fiscal deficit edging back up (a result of politics and the desire of the ruling Congress Party to secure the support of rural voters in upcoming elections during the next three years)
- Central fiscal deficit could exceed 5%; combined with state deficit, it could be close to 10%
- When the current government came to power in 2009, there were hopes for reform, but this has not materialized. The main reason is politics.
- A central concern of the Congress Party is a focus on India's poor and various redistributive income transfer schemes employed over the past 7 years.
- A food security initiative under consideration would guarantee 25 or 30 kg of grain per month to families living in poverty; the poverty line has been revised up to include more beneficiaries if this program is ever implemented.

Participants discussed the proposal to create a core G-10 organization of developed and developing nations based on objective criteria, instead of G-8, G-5, and G20, because these countries have not been selected based on objective criteria.

The standard for membership in G-10 would be based on objective criteria:

- Country's percentage share of GDP in world economy
- Percentage share of population relative to world
- Sum of these 2 figures
- Divided by 2

Calculation will be made on this number for each country and the best 10 will become members of G-10.

The business of G-8 would be conducted by the G-10. In addition to G-8 business, three important issues related to trade policy must be addressed:

1. Trade and climate change
2. State-owned companies and trade policy
3. Trade policy and resources

Participants discussed political and ideological barriers to successful implementation of the G-10 proposal. For example, newly admitted countries would need to be convinced that they have an equal seat at the table and an equal stake in policy outcomes. A change of the guard would need to take place. Like a baseball or soccer team, the team defeated often will drop down to the minor leagues. This is the logic.

Participants discussed Mario Draghi's decision to cut ECB interest rates. It was noted that Mr. Draghi will likely be careful to lead the ECB along a consensus line. Concerns about the French and German banking systems are paramount now. The current problem is not Greece, which has a relatively small GDP. The biggest challenge is the exposure of European banks to sovereign debt. When mortgage backed securities slipped, regulators in Europe bought sovereign debt because of its perceived stability.

Participants discussed the role of China in the global economy. It was noted that from a unit-labor-cost perspective, Chinese wages have not grown as fast as productivity has risen. The four biggest banks in China are state owned, as are many small banks. Wage gains during the past year have been 20%. There is also a wave of small manufacturing firms in eastern China that cannot raise prices because of the renminbi. These firms have higher fixed labor costs.

The Chinese population will decline from 2015 forward, and the labor force will decline after 2020. This is good news for the Chinese people. This will force an economic shift to different industries and an overhaul of the industrial structure to higher tech or higher value industries. This is the natural process in developing countries. As countries begin to export more, they need to pay higher wages as their productivity increases. China may have been able to put this off due to its political system, but the pattern cannot be delayed forever.

To the extent that this is natural and government does not prevent wages from rising, if consumption goes up, so will imports. This is a potential source of growth for developed economies.

The number of changes that China needs to undergo during the next 10 or 20 years is staggering, even when considered against the changes that have happened during the past three decades. China's economic system is embedded in its political structure. Incentives must be shifted and modernized.

Session III: Identifying New Sources of Growth – Agenda Items for the 2012 Chicago G8 Summit

It was noted that there are two ways to promote growth:

- Government spending
- Deregulation

A change is taking place within capitalism. It was previously thought that internal discipline was in place, taking care of employees, depositors, and other stakeholders. The financial crisis that culminated with the fall of Lehman Brothers revealed that capitalism was abusing this freedom. Consequently, it has become necessary to impose discipline through increased governmental control.

The level of control needed depends on the sector in question. The financial sector, for instance, needs more regulation than other sectors. Outmoded regulatory regimes still exist in some sectors. For example, local beer brewing was prohibited in Japan until 1994. Also, regulations regarding robotics could be lifted to re-invigorate the Japanese economy. Deregulation could work in Europe. If Europe succeeds again, then Japan will also once again succeed.

Presentation: Japanese Perspective

Inflows of foreign direct investment (FDI) to the global South have increased. In 2010, the South absorbed over 50% of global FDI flows for the first time. Developing countries have strengthened their presence as investors. Outflows from Hong Kong and China increased by more than $10 billion in 2010, as compared with 2009. Also in 2010, six developing countries were among the top 20 FDI investors globally.

The global South is becoming more important as a destination for FDI. Developing countries have strengthened their presence as investors. The main direction is from South to South. Chinese FDI to the U.S. is just 2% of its investment globally. However, investment from South to North is also increasing.

Various non-tariff barriers exist in South-to-South and North-to-South investment. Creation and implementation of appropriate rules is the key to reform.

Obstacles include:

1. Sudden changes in regulation
    a. Legal uncertainty
    b. No notice before regulatory changes
    c. No consultation with public before changes are implemented

2. Protection of intellectual property
3. Handicaps against foreign business
    a. Capital controls
    b. Local employment requirements
    c. Local procurement and content requirements

Improvement of the business environment is important for promoting FDI. Legal provisions, including bilateral investment treaties, can be a basis for creating a legal environment that is friendly for business investment. Multilateral investment agreements should also be pursued to promote and protect FDI (South to South and South to North). These key provisions should be included in legal agreements:

1. Transparency
2. Due process
3. Non-discrimination
4. Prohibition of requirements on technology transfer, local content, and local employment
5. Effective dispute settlement procedures

There are numerous reasons for the current Doha Round impasse:
1. Substantial gaps among major countries
2. An evolving global economic structure, including an increase of responsibility shared by emerging economies
3. 153 WTO member countries with veto power
4. The wide range of topics under discussion as part of the negotiations

Further, there is no shared sense of responsibility among WTO member states. In contrast to the Doha Round, the Uruguay Round benefited from a shared sense of responsibility between the U.S., Canada, Japan, and the EU for concluding negotiations.

Protectionism poses a huge risk for the global economic system. Protectionism can never be an answer. A new mechanism is needed to deal with trade challenges and tackle the conclusion of the Doha Round. The political will of leaders is essential. Currently, G-20 leaders are just discussing financial issues. They need to look at trade issues as well. Engagement of the business community is also essential. In addition, WTO member states need to explore ways to deal with variable geometry, which means confronting changing business needs and a changing business environment. A plurilateral approach is another way to move trade forward. Regarding an FTA approach, the Trans-Pacific Partnership is a very hopeful development.

Presentation: U.S. Perspective

Should G-8 nations outline a framework for a new sustainable economy that provides a new model for growth? Finding new sources of growth in G-8 countries is a pressing challenge. The world does not have a growth problem – G-8 nations do.

G-8 countries are generally very wealthy. However, they face numerous challenges to growth:

1. High unemployment
2. Stagnant real incomes and growing inequality
3. High public debt
4. Unfavorable demographic trends

Within most industrialized aging G-8 states, growth is elusive because firms are relocating to rapidly expanding markets. G-8 firms can prosper due to their ability to relocate labor and capital, but what about their home markets?

The world has watched the shift from developed to developing markets. This is increasingly the result of corporations' desire for proximity to the fastest growing end markets, which are now in Asia. The pressing issue for G-8: since the world does not have a global growth problem, major emerging markets have been in spirited battles to constrain growth. It is therefore important to outline certain successes in G-8 countries at the firm level, which might suggest new public policy ideas to promote growth.

There is a consensus developing that regulation places a serious constraint on growth. For example, U.S. Senator Susan Collins (R-Maine) was quoted as saying that business needs a "regulation time-out" on new rules that would adversely impact jobs, economic growth, and America's international competitiveness. Also, *The Wall Street Journal* commonly excoriates new regulations implemented under Obama administration.

It can be argued that this preoccupation with overregulation misunderstands the issue of competitiveness at the firm level. Fixation on over-regulation is driven by ideological - not empirical - grounds. In Europe, for example, many firms have done well despite high regulatory standards. In Germany, there are high standards for waste disposal and engine emissions, and there are high taxes on energy. Germany has the lowest unemployment rate in Europe. German automakers have excelled in the exports market – they now occupy the top three spots in exports to China.

High standards have been at the center of innovation. Instead of creating a high cost burden, high standards have made German firms more competitive in the global marketplace. Japan is no different than Germany in this regard. Japanese firms lead many niche markets globally, and regulatory standards are very high in Japan. Food safety and air and water quality are becoming increasingly important in developing nations. Japanese firms will be well placed to sell their products in these markets.

China produced over 11 million passenger cars last year, so there is a huge potential for implementing high technology production standards – technologies that will come from Japanese and European suppliers, for example. Many Chinese firms are making good production investment decisions.

G-8 firms that want to maintain relevance must work hard to maintain technological leadership. They must analyze reasons for technological advances and ways to market these advances. This dynamic can be seen as a change from the proverbial "race to the bottom" back to a "race to the top."

Internationally shared standards on pollution, safety, and efficiency might be a place to start. Ideas and technologies are very mobile. Advanced economies may not always be able to maintain a productivity edge, but our systems of governance and regulation can motivate firms to stay ahead of the game while continuing to innovate.

Discussion

One participant discussed a communiqué recently issued by the BRICS countries (Brazil, Russia, India, China, and South Africa). This document underscored support for the international order created at the end of World War II with U.S. leadership, including the WTO and IMF. It went on to deplore the failure of the global community to reform this order and to better reflect the tectonic shifts that have taken place in the postwar period. Most notably, there has been a shift of resources and economic activity to the East and South.

Regional and bilateral trade agreements are proliferating around the world. Participants discussed the proposition that these agreements are called "free," and suggested they are all discriminatory and diversionary. The proliferation of free trade agreements threatens to undermine the WTO. Some say that it will be cheaper and more efficient to ignore all of these rules.

Participants discussed the suggestion that monetary integration and union have made very little progress in East Asia. The world has lost its reserve currency. There is a need to modernize and reform international institutions, which have not changed since 1945. Europe in effect manages the IMF, and the U.S. in effect manages the World Bank. The question was asked: Who will step up to the plate and begin to update these institutions? A new global regulatory regime and financial resources are needed in future. Is a new reserve currency the solution? Or a multi-currency regime?

The group discussed future sources of leadership in the arena of global trade and governance. It was suggested that the U.S. is marginalizing itself. The U.S. and Japan have dysfunctional politics. China is being characteristically diffident. One participant recommended that a network of think tanks and universities can be put together to consider possibilities and keep discussions away from the political realm for now. Cooperative effort among academics and research institutes worldwide could go a long way. It was suggested that the WTO is not ready to discuss changes in its governance process. No process is in place to reach a conclusion at this time. It was suggested that the WTO could create a committee to discuss ideas for reform.

Another participant noted that bank regulation is moving in an interesting direction now. Banks are highly leveraged institutions. They maintain a certain amount of capital, which corresponds to how much they can lend. The trend in U.S. and international regulation is to increase capital requirements. In theory, this makes financial institutions safer. However, higher capital requirements can lead to reduced lending, which in turn lowers economic growth. The question is this: as policymakers get together to discuss new sources of economic growth, should this be discussed? Has research been done to assess the impact of higher capital standards on economic growth?

Participants discussed the price of credit, which can be viewed as the most important price indicator in an economy. Lending institutions in the 19th century had unlimited liability, and leverage ratios were drastically dissimilar to what they are now (much lower). Has the cost of money increased to the extent that it can constrain growth? From one perspective, the problem with banks is a malformed structure of incentives. CEOs have the opportunity to increase earnings, and they get paid a lot of money and assume no personal risk of financial loss.

One participant noted that in the long-term, experience has proven that the extra investment costs related to higher regulations are beneficial at the firm level. In countries like the U.S., our expectations on return on investment are very, very short-term. The Germans and Japanese take a longer term perspective. When you build in the cost of regulations, they are a very modest cost on top of total expenditures.

Participants discussed the role of shareholders. One participant suggested that today's companies are not designed to think about G-8 citizens. They are only designed to think about shareholders. Is there any uniform system of accountability that can be implemented globally? The U.S. seems to be making some effort to address these issues outside of its own borders.

One participant suggested that when externalities exist, they should be regulated. The key question is not whether to have more or less regulation, but instead how to develop wise regulation – particularly with regard to financial markets. Also, the issue of moral hazard and regulation is an important question. A participant noted that we should prevent the formation of banking sector institutions that are too-big-to-fail so that institutions can fail without threatening to bring down the entire market with them. Another participant noted that once you have a regulation, it is very difficult to get rid of it. There is no mechanism to eliminate a regulation that is outmoded. It was suggested that new regulations could be created with sunset provisions to avoid this problem. It was further noted that constituencies tend to develop around regulations regardless of sunset dates, thereby contributing to the inevitable lifespan extension of the regulation in question.

One participant suggested that we should first address legal and institutional corruption in the U.S. before targeting reform in other countries. It was suggested that the U.S. might experience a higher rate of economic growth if its political system was cleaned up. Growth depends in part on the evolution of institutional thinking.

For example, infrastructure investment is a much better way to create jobs than defense spending. Education is also a better way for government to spend money for the purposes of job creation.

Participants discussed Japan. Someone noted that the very nature of the Japanese people has not changed at all, i.e., the Japanese are a very diligent and hard-working people. The real problem is the Japanese social system. In Japan, the manufacturing sector is like West Germany. The non-manufacturing is like East Germany. The agricultural sector, for example, is highly inefficient. The manufacturing sector, which led Japanese growth previously, is leaving Japan.

Other sectors need to be deregulated in order to increase market competition and make higher growth possible. Inefficient, highly regulated/protected sectors need to become more productive and competitive.

One participant suggested that it is important to remember that during the past 150 years, Asian renewal started in Japan. When considering the recent period of economic stagnation in Japan in the context of its declining working-age population, increasing challenges to its technological leadership, and diminishing geopolitical relevance, can we look to Japan for a radical departure from the past for global renewal? Or will Japan simply continue to muddle through its third lost decade?

Conclusions and Recommendations

Michael H. Moskow

Mr. Moskow provided a recap of the day's discussions. Bubbles in various countries resulted from different causes. In Japan, the bubble was caused by excessive corporate borrowing. The U.S. financial crisis was precipitated by a housing bubble, and Europe now faces a sovereign debt problem.

Japan can be viewed from a structural standpoint as a two-tiered economy. The first tier, consisting of the manufacturing sector, has high productivity growth (but this sector is shrinking as a percentage of the economy). The second tier, consisting of agriculture and other protected sectors, has lower productivity growth. Overall productivity growth in Japan is slowing.

If the newly proposed Trans-Pacific Partnership (TPP) is agreed to, protected sectors in Japan would be opened to competition, thereby stimulating growth and improving efficiency.

In the United States, the rate of growth has been faster than Japan. U.S. growth should be 2.5% on a long-term basis. Japan's growth rate is slower because its population is not growing. However, the U.S. is experiencing slow and sluggish growth because it is coming out of a recession caused by a financial crisis, which traditionally means that a recovery will be slow and sluggish.

A significant risk for the U.S. and Japan is Europe. How serious will the recession be in Europe? Forecasts for economic growth all over the world are coming down. The ECB could solve the liquidity crisis by agreeing to buy Italian and Spanish bonds.

We also discussed the idea of a consumption tax that could be imposed now and gradually increase over time. According to this view, this would have the effect of encouraging consumption now (when consumption tax is raised step by step, people would be rushed to buy before tax hike). This would be similar to reducing interest rates in its effect on aggregate demand. However, a consumption tax may not be politically possible in the United States.

Emerging markets are very important. China is the largest emerging market. In India, economic growth is beginning to slow down. There has been no serious political reform thus far in China. When will this occur? (There was also a discussion to introduce consumption tax on internet trade to secure enough tax revenue.)

Europe poses a very serious problem and raises many questions related to regulation and the role of government. It was suggested that the most important question regarding the role of government is not whether to have more or less regulation, but instead how can we create wise regulation that will spur growth? Externalities can be captured through regulation and taxation if implemented wisely.

Noboru Hatakeyama

Earlier, there was a reference to a carbon tax and a reference to elasticity. However, there was no discussion about a cap-and-trade system. Cap-and-trade is an interesting scheme to be discussed further. What I meant by climate change implied the necessity of discussing cap-and-trade. The group elaborated on the economic situation in India. Why is there such a high growth rate in India despite infrastructure problems?

The proposal to create a G-10 might be rejected in a very decent manner, but it might serve as the beginning of the game. This is critical because the world needs to be democratized and cannot be ruled only by a few countries. Developing countries like China, India, and Brazil should be in a position to have their own place at the table and not be taken for granted.

Concluding Remarks

Mr. Bouton thanked Mr. Hatakeyama and Mr. Moskow for their leadership of this entire effort to bring together this group for a very stimulating and informed discussion. He noted that there have been many mentions of a need for political leadership around the world. This reminds us that for all the science of what we have been discussing, at the end of the day, when the world is in this kind of a situation, without bold leadership, it is tough to consider that imaginative suggestions can get a hearing or be implemented. Let's remember what put the G-20 at center stage – it was the 2008 global financial crisis. It might take another crisis to reach a resolution on how global governance is executed. On the other hand, we would rather not experience such a crisis in order to achieve these reforms.