*"Is the world economy's recovery sustainable?
A viewpoint from Europe and Japan"*

**Summary of the ninth edition of the Europe-Japan Conference,
held in Paris on December 9-10, 2010**

25 participants attended the ninth edition of the Europe-Japan conference co-hosted by *Japan Economic Foundation* and *Institut Aspen France*, which was organized in Paris on December 9-10, 2010, at the *Conseil économique, social et environnemental*, with the support of the *Comité d'échanges franco-japonais*.

The issue of global convergence and divergence among economies was central to the debate. Also pivotal was the discussion about the drivers for transformational changes in society, both in Europe and in Japan.

The economic outlook is not uniform globally. While in Brazil, in South Korea, in Taiwan, in Australia, the gross domestic product (GDP) stands at a much higher level now than at the start of the global crisis, the US, Europe and Japan have been severely hit by the downturn. The latest evidence available suggests that the output loss suffered by the American economy because of the recession will be permanent; its trend growth rate should remain unchanged, however, at about 2.5%. Japan, where the trend growth rate over the 2000-2008 period amounted to 1.65%, experienced a sharp fall, followed by a catch-up. In the euro zone, a discrepancy can be observed between the German economy, which grows by 1.2% on trend, but has recently recovered by a 3.4% rate, and the French economy, where the slightly higher pre-crisis trend growth rate of 1.8% most lately turned into a sluggish recovery by about 1.5%.

The global recovery is no longer gathering pace and can even be deemed tentative. Final demand remains weak overall, especially as the US households, which are the traditional engine of the world economy, are still overleveraged. The ratio of household debt to disposable income, which rose steadily since the early 1980s, has now reached highs where it no longer fosters consumption, whose share of GDP remains stuck, slightly above 70%. Private debt on the corporate side cannot make up for that lack of steam, as the crisis led companies to tighten their belts and to focus on key critical indicators such as positive free cash flows. Cutting fixed costs is for them an utmost priority and one-off restocking should not be mistaken for sustainable recovery. Deleveraging is especially spontaneous in the financial services industry and is enhanced by the various taxes levied on banks, which cause a tightening of interbank lending[1]. In that context, the so-called "Swiss finish" sharpening capital constraints may be redundant.

Uncertainty does not affect only the growth path, but also the pace of core inflation. The short-run risk of deflation is looming in Japan and, to some extent, in the US. It seems a more distant threat for Europe. The link between deflationary pressures and labour market flexibility is controversial. Wage flexibility appears to have increased in Japan, as salaries have started to decline nominally. This overall picture has to do with job market disparities, though: it could stem from a combination of the flexible wages of non-regular workers and the non-flexible wages of regular workers. Meanwhile, in Europe, wage rigidity remains stronger, in part due to deep-rooted labour unions, which allows for simultaneous unemployment and inflation. As for the US, two anti-inflationary drivers can be identified:

- rents[2] already capture over one fifth of household income and should then plateau ;
- prices of services are declining, because the weak labour market puts downward pressure on unit labour cost.

This leads to accommodative and increasingly innovative monetary policies in the US, in Europe and in Japan. Close to zero rate policy is now taken for granted, and refinancing measures such as the facility set by the European Central Bank (ECB) have formed part of the policy response to the crisis. This increase in base money while capacity remains underutilized has fuelled a rise in asset prices. How inflation targeting[3] can prevent the structural risk of deflation remains a vexing question. As the quantitative easing embarked on by the Federal Reserve shows, more can be needed to change inflation expectations. This latter objective seems all the more pivotal because deflation would increase the real value of debt for households, which would have dire consequences. This issue is not only a private one, however: the level of real interest rate is also key to public indebtedness in countries where it is high.

[1] It should be noted, though, that in Japan, banks do not rely as heavily on interbank lending as their American and European counterparts.

[2] Including imputed rents.

[3] The ECB has no formal inflation targeting but succeeds in keeping the inflation rate close to 2%.

The debt overhang that monetary policy has to take into account leaves little room for manoeuvre to the fiscal component of the policy-mix. Fiscal consolidation cannot be escaped. Postponing that adjustment with a view to preserving a still fragile recovery would likely be pointless, as we can learn from the lessons of fiscal policies in the US and in Japan in the 1930s : the American New Deal failed to engineer systemic growth despite the rise in public debt, and the unemployment rate remained stubbornly high. For want of a Canadian-style consolidation, the only way to avoid monetization of public debt (and the consequences that come with it) is to gradually decrease the budget deficit by reining in tax loopholes, which requires political commitment. In Japan, this could be supplemented by a rise in the personal consumption tax rate, which still stands at only 5%. Such a rise could both increase government income and foster inflation. Although the introduction of indirect taxation caused strong negative reaction in the 1990s, the average Japanese consumer and taxpayer now seem ready for an increase in personal consumption tax. That move might yet not be enough. Capping government debt by setting a ceiling could also be necessary. Overall, the key of fiscal sustainability appears to be confidence, not macroeconomic data.

Excessive levels of debt reflect global imbalances. It is estimated that four Asian countries hold about 25% of the total US public debt. About two thirds of the aggregate of international reserves now sit in Asia. With 60% of the world population, Asia stands for 20% of global consumption, while the US is host to 5% of the world population and accounting for 30% of worldwide consumption. The rebalancing of these conflicting patterns can only occur over the medium run. In the US, the saving rate of both households and the government has to be enhanced: this trend is under way but may have to be enhanced by structural reforms, pertaining notably to the tax system. Japan and Europe would then witness a curb on spending habits in the US, which would need to be offset by turning the economic success of emerging countries into a rise in domestic consumption. Building social security nets will contribute to that goal – but cannot be achieved over a short term.

Solving global imbalances poses a policy dilemma resulting from Mundell's incompatibility triangle[4]. Raising the interest rates in China would help defuse inflationary pressures and risks of an asset bubble fuelled by the piling-up of international reserves. Fine-tuning would be needed, though, so as not to hamper growth. Such a move may also take time because of the internal governance context and decision-process. As regards the appreciation of the yuan rinminbi (RMB) versus the US dollar (USD), what is at stake is less whether it will take place than what the pace of the adjustment will be. Should the RMB be floating freely, the huge current surplus run by China since 2005 would have triggered a stronger

[4] Its components are a fixed currency, free flow of capital and an autonomous monetary policy.

appreciation of the RMB exchange rate than the one that actually occurred. Still, the impact of this revaluation on the American and European trade deficits should not be overestimated. Japan's experience in the 1980s is insightful in that regard. Even after the quasi-doubling of the exchange rate of the Japanese yen (JPY) to the USD over the period 1985-1988, the US trade deficit with Japan continued to increase. The appreciation of the RMB will most likely be gradual. It should also be noted that so far, the use of the RMB in currency transactions remains marginal. It is estimated that it lags behind that of the Malaysian ringgit or the Thaï baht. Meanwhile, 90% of currency transactions still involve the USD. The US position as the largest net external debtor does not necessarily translate into a depreciative overhang, as its numerous creditors share a cause for concern: any collapse in the USD exchange rate would send the value of the stocks and bonds they own nose-diving. The global economy could then fit in a multi-polar currency system – with regional blocks being echoed by several currencies. Having no private base, special drawing rights (SDR) look bound to remain only a reference of accounts, not an actual currency.

Japan's economic position in that context is somewhat stand-alone: while rather insulated from the global interdependence, it also sidelined when it comes to cashing in on the rebalancing of global growth, which is now Asia-based. As it is less interconnected and less reliant on international capital markets than most advanced economies, Japan could somehow weather the global turmoil. The stock of its public debt is high but largely held by domestic investors. This prevents a downward strain on the JPY, all the more so as upward drivers are simultaneously at work: the Japanese economy attracts foreign capital as it has to offer few constraints and high liquidity to investment. A new *endaka* could then take place, which would hinder progress towards recovery. Meanwhile, Japan is not the country benefiting the most from growth in Asian emerging markets[5]. China's story is essentially about supply so far. An increase in manufactured and high-value-added exports to China is therefore pivotal. Such a trade expansion would be mutually beneficial.

Divergence in economic performance makes it harder to coordinate globally on macroeconomic policy and governance. Even advanced economies do not have their interests aligned: capping trade surplus as a percentage of GDP would be detrimental to a country like Germany, which led it to joining China and other emerging economies in criticizing the US stance on that matter. The current G20 format can be given credit for allowing on board key countries for global governance, like Mexico, South Africa and Russia. However, more needs to be done so that the concluding consensus of each meeting comes with indicative targets and provides a framework for medium-term adjustment. A more radical approach

[5] Evidence of the rise of emerging market companies is given, for instance, by the Fortune 500 rankings.

would be to consider that the current perimeter of the G20 causes time-consuming coordination without effective results, for instance as it has no visible impact on China's currency policy. A proposal to reduce the number of member countries to ten can then be put on the table: admission criteria would combine equally population share and GDP share. In such a format, member countries would be the US, China, India, Japan, Germany, Brazil, France, the UK, Italy and Indonesia.

More focused cooperation can be achieved through the partnership between Europe and Japan, in a renewed framework. Japan trade used to be dependent primarily on what happened in the US. The US is still a key partner, especially in terms of regional security. However, Japan has to diversify its alliances: on top of applying for membership to the Trans-Pacific Partnership (TPP), it is pushing for the finalization of the Economic Integration Agreement currently under negotiation with the European Union (EU). The stalling of talks in the World Trade Organization round would make this alliance between two sustainable leaders all the more relevant and necessary, as companies and the man on the street alike can clearly perceive. It should be framed not as a zero-sum game, but as a win-win initiative, with a far-reaching range. Its scope could include environmental issues. Evidence of the cooperation between Europe and Japan on these matters will hinge on the decision about the Kyoto protocol. The green involvement can be multi-fold: being a member of the United Nations Framework Convention on Climate Change (UNFCCC) can be complemented by signing bilateral agreements. The International Partnership for Energy Efficiency Cooperation also provides concrete example of environment-conscious projects put to work. Another pillar of the Japanese partnership strategy is the development of ASEAN+6 and the East Asian Community. Given that Asian countries have various cultural backgrounds, it should be expected that different types of common markets emerge. However, further integration can get increasingly difficult to achieve, because of integration fatigue and diminished confidence in the role of the market.

Europe and Japan can also promote shared views on capitalism and corporate governance. Being out of the Anglo-Saxon community, which traditionally frames the way market works, can create an affinity and trigger the will to build an alternative model, as depicted by Michel Albert in *Capitalisme contre capitalisme*. While in the years following the end of the cold war, corporate governance models converged towards the US dominant pattern, where size matters and profit maximization is at the core, mindsets started to change in the 2000s, in the wake of 9/11, the Enron fraud and the recent crisis – for which, apart from a wrong monetary policy, poor risk management at firm level and lax supervision by the public authorities were to blame. Criticism of the prevailing approach to compensation, to governance, to compliance and to potential conflicts of interest grew and reached a turning point: the political pressure is now strong to penalize banks, big businesses and the rich. “Skin in the game” as provided for in the Dodd-Frank Act and a better monitoring of rating agencies are only part of the answer. Time has come of the promotion of stakeholders’ capitalism, with moral hazard and compliance awareness as well as an ethical dimension that should be more extensively taught in business schools. The future may belong to capitalism with caring spirit. It is up to Japan and to Europe to give evidence of their commitment to set new market standards and make their enforcement as homogenous as possible. This might be deemed a battle of the past, but lying idle is not an option. Indeed, emerging countries are promoting a governance model of their own, epitomized by bulge-bracket large corporations that may be listed but usually with controlling shareholders remaining (be it a founding family or a government authority), are no alien the political decision process and are meant to contribute to national economic expansion.

Building an alternative capitalism model can lead to greater public intervention, although a trade-off has to be made between the risks of market failure and of government failure. There are several hints at a fruitful government comeback: in emerging economies such as China, many successful firms are state-owned; in advanced countries, government support to banks most often ended at a profit with a flattering return on investment. A cautious and balanced approach should yet prevail, given the risks of overregulation or inadequate government intervention. For instance, there can be political incentive and public opinion pressure into supporting declining, labour-intensive industries, with zombie funds, while a greater reward would come from public capital investment in promising new ventures.

Collective preferences within the society stem largely from demography. Ageing is a matter of concern for advanced economies, first and foremost Japan, where the downward demographic trend results in a negative contribution to the breakdown of growth factors. Supply has to adjust to demand that is, all other things being equal, shrinking due to the decline in population. Off-balance sheet public debt relates mostly to pensions, hence the need to increase the number of contributors and decrease the number of recipients, by fine-tuning the set of actuarial incentives and penalties, whatever the vested interests - especially by raising the retirement age. Labour force participation for the population aged between 55 and 64 is much higher in Japan than in France. In both countries however, the issue of social cohesion is at stake, outlining the need for income transfers between generations.

Ageing also shapes customer expectations and consumer lifestyles. Convergence with the Western wealth standards was sought by Japanese consumers in the 1950s and the 1960s. The 1970s and 1980s saw an expansion of mass consumption, especially in Japanese department stores, with clients increasingly demanding product quality. While the early 1990s did not follow that expansion trend, making life more comfortable was still the top on the consumer's agenda. However, 1997 marked a shift in expenses; from then on, the Galapagos phenomenon, which consists in using standards of their own, not shared elsewhere, rose. Japanese ageing population has become a quiet people and wants to live a life that reflects its own culture. Doubts about what the future will look like lead to a nostalgic feeling, for instance towards the Meiji era. Even the youth are inward-looking, as their music tastes and their appetite for mangas show.

Mature markets can provide economic opportunities. Clients pay a growing attention to the service offered, which should be personalized. The tailor-made approach has taken over the one-size-fits-all. Customer expectations go further than mere consumption: it is about living an experience, for instance by travelling off the tourist track. Exchanging art-de-vivre is an engine for exchanging business-wise. Moreover, customers' greater sense of responsibility and awareness of environmental and health issues refine their wishes, which now typically include sustainable development. Lastly, ageing-related industries, like care and pharmaceuticals, are a field of business opportunities. The aim is to turn this silver market into gold.

Instilling a forward-looking attitude in ageing societies remains a challenge. Japanese and European business environments are well-organized and mostly efficient, but the underlying mood is risk-averse and too defensive. The US is by and large the most innovative of advanced economies, several notches ahead when it comes to entrepreneurship spirit. Although business establishment is shifting and mavericks command increasing respect, Japan and Europe remain too often crippled by the fear of novelty and failure. Mindsets should be rebalanced to more risk-taking, which would translate for instance into more speedy, start-up funding at an early stage.

Business internal organizations and external interactions should become more collaborative. Japanese firms remain dominated by the concept of hierarchy, whereas horizontal relationship, which is less slow and less bureaucratic, is now desirable. Women are still largely excluded from jobs with top responsibilities, let alone companies' boards. Allowing work-from-home and setting more day-care solutions are pivotal to allow more women to take part in the job market. Collaboration is also key to foster innovation, on top of the in-house innovation for which Japan fares well. In that respect, intermediary institutions like venture capital firms and incubators, which build bridges between academics and businesses, are missing in Japan. More cooperation between Europe and Japan, through joint funding, people exchange, common research and development, would be productive.

Innovation is a key growth driver in mature economies. Technology can provide a decisive contribution to total factor productivity, including in the services and retail industry with an appropriate use of information technology (IT). Overall, being selective, as Japan did with its nine knowledge clusters, is a condition for success. Among the right segments for Japan and Europe to pick, stand life sciences, innovative medicine, IT, nanotechnologies, sustainable products, environment and energy efficiency as well as the monitoring thereof, and infrastructure. The underlying innovation can be scientific and technological, but also service-oriented. To create the conditions for such innovation to happen, governments should focus on stimulating investment and promoting a fertile business environment – like Germany's Mittelstand. Innovation can solve many of the dilemmas and challenges that are faced by Europe's and Japan's economies (leading to enhanced competitiveness) and societies (driving a shift in mindsets).