

White Paper

on International Economy & Trade 2008

COVER STORY • 1

Current State of World Economy & Strategies for Japanese Economy

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Looking first at the long term, factors such as the subprime mortgage crisis have pushed the US economy into an adjustment phase since mid-2007. More recently, resource and food prices continue to soar. Steep oil and food price rises are impacting heavily on the developing world, particularly Asia and Africa where many people subsist on less than a dollar a day. As such, this price trend is gaining prominence as a risk factor for the world economy that rivals the seriousness of financial uncertainty.

Given these conditions in the world economy, Japan needs to continue serving a key function as an Asian innovation center, while also developing a new development strategy for working with Asia to guide the world economy onto a sustainable development trajectory.

Accordingly, the 2008 White Paper on International Economy and Trade lays out a national strategy based on the creation of three markets. One is a “five billion-person market” centering around resource-rich countries and developing countries that will power a virtuous cycle for the world economy; another is a “greater Asian market” centered on Asia, which has strong ties with Japan and will provide a development base for Japan and Asia; and the third is a “market for sustainable development,” promoting engagement with global issues such as climate change, food shortages and poverty. These three markets are explained in greater detail below.

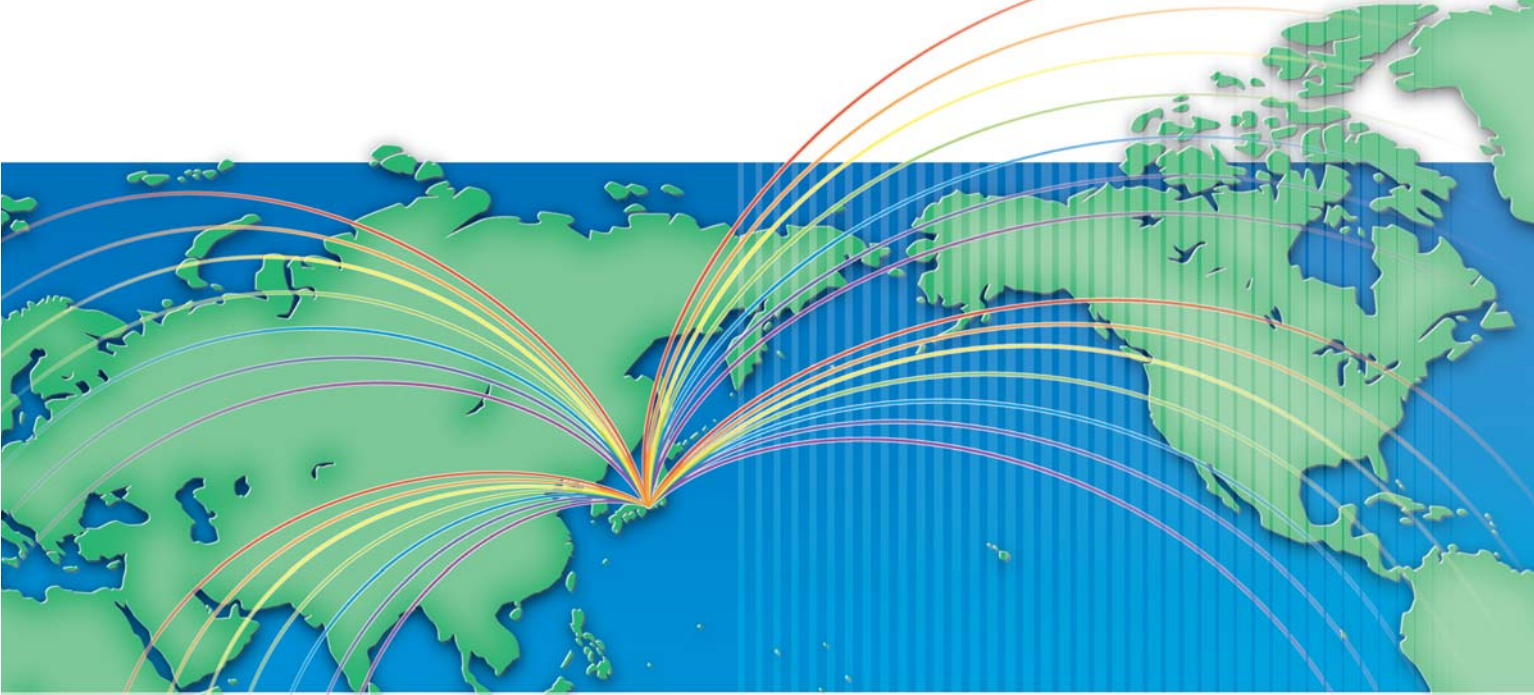
1. Prospects for New Development through “Five Billion-Person Market”

(1) Globalization risks

The world economy currently stands at a major turning point. Amid economic globalization — namely, the global expansion of the stage for various economic activities — increasingly efficient global resource distribution and rising

productivity have underpinned rapid and sustained economic growth.

At the same time, the increasingly dynamic movement of money and goods in particular is foregrounding some major risks for the world economy: the subprime mortgage crisis, which has extended out from the United States, and the inflationary pressure created by skyrocketing prices as resource supply tightens in response to growing demand



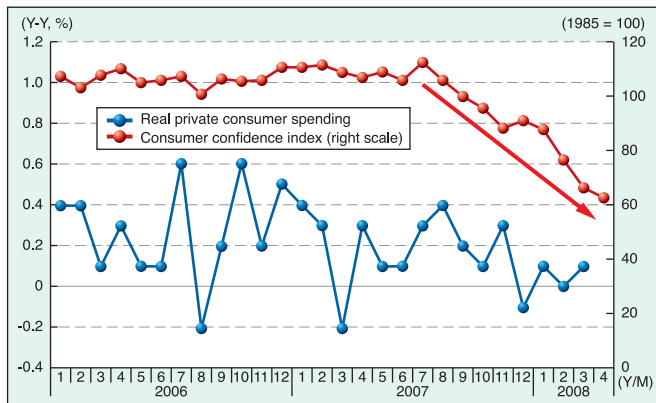
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from China and India in particular.

For example, where the United States was until recently driving the world economy on the strength of robust domestic consumption, the emergence of the subprime mortgage crisis has forced the country into an adjustment phase sufficiently serious as to raise the prospect of stagflation (*Chart 1*). International financial markets have also been shaken, and there are fears of an international ripple effect on real economies due to the impact on credit creation functions and the linkage among national economies created by trade and investment.

Meanwhile, economic growth in China and India as emerging markets with massive populations has sent resource and food demand soaring. This in turn is tightening supply and pushing up prices worldwide, bringing inflationary pressure to bear on the world economy as a whole.

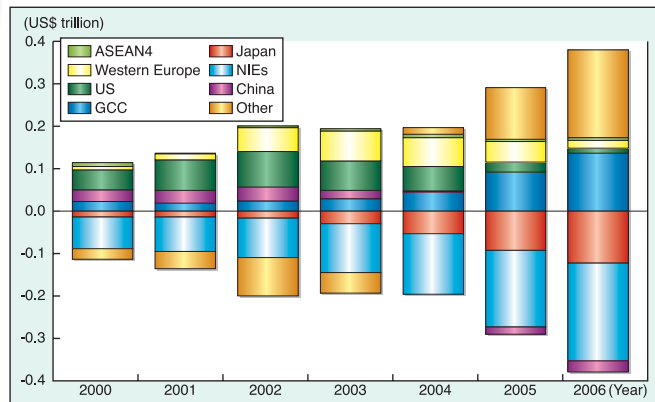
Chart 1 Rapid deceleration of US consumption, which accounts for 25% of world GDP



Source : Bureau of Economic Analysis, US Department of Commerce; US Conference Board

Chart 2 Trading profits positive for resource-rich countries, negative for Asia

Trends in trading profits and losses in major countries/regions

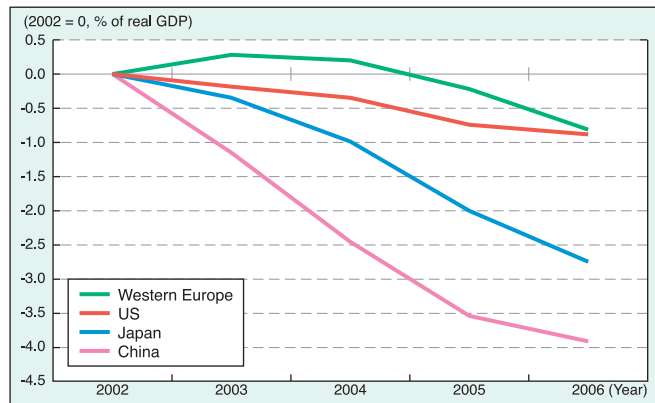


Note : Base year = 1990

Source : National Accounts Main Aggregates Database, United Nations

Chart 3 High oil prices worsening all major powers' terms of trade

Trends in trading profits and losses in major countries/regions



Note : Western Europe here is as designated in UN statistics, including Austria, Belgium, Germany, Lichtenstein, Luxembourg, Monaco, the Netherlands and Switzerland.

Source : National Accounts Main Aggregates Database, United Nations

Skyrocketing resource prices are worsening terms of trade for all the major powers (Charts 2 & 3).

The manifestation of these risks is expected to prompt a slowdown in economic growth rates worldwide. The emergence of global risks on both the finance and real economy fronts demonstrates the high degree of linkage and integration among national economies in both these aspects. In this sense, it stands as a vivid symbol of ongoing world economic integration. Simultaneously, however, the causes of these risks and the ripple-out process epitomize the multi-polarization of the world economy (Chart 4).

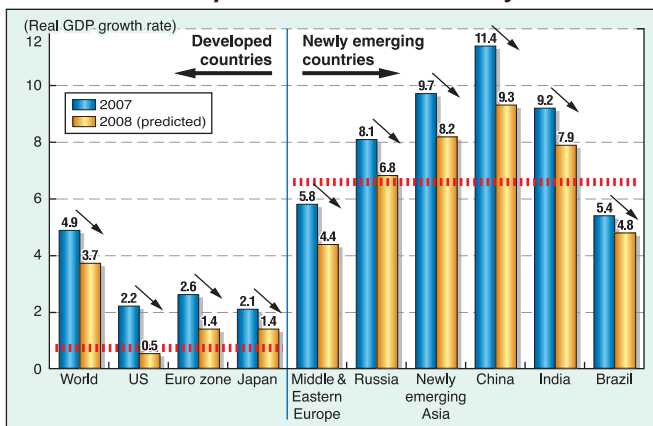
(2) Virtuous circle created by linkages among newly emerging and developed countries

Amid all this, with the cross-border movement of management resources — people, goods, money, knowledge and know-how — becoming increasingly active, the economic scale of the newly emerging countries has more than doubled over the last five years, integrating high-growth newly emerging countries with a population of four billion into the world market.

As the global economy reaches a watershed, a new engine for sustainable development has become vital. Eyes are turning accordingly to the “five billion-person” world market arising from linkages among the billion people in the developed world and the four billion in the emerging countries that have recently entered the world market as part of the globalization process.

In addition to the newly emerging countries, there are also the resource-rich nations, where consumer markets are currently thriving thanks to elevated resource prices. Countries that can export to these markets have been using net exports to channel back wealth outflows, with this reabsorbed wealth underpinning their economies (Charts 5 & 6).

Chart 4 Simultaneously integrated & multi-polarized world economy

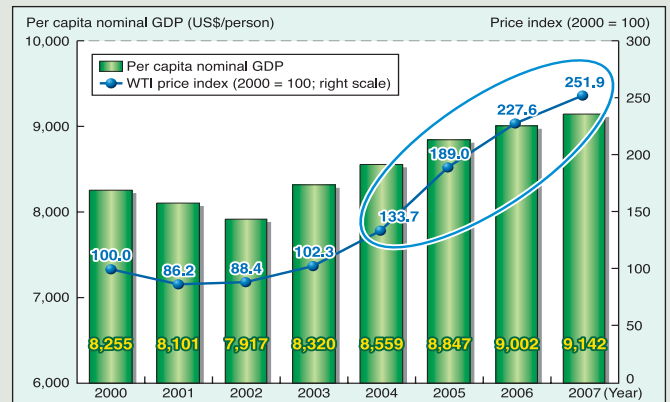


Source : World Economic Outlook (April 2008), International Monetary Fund (IMF)

Chart 5 Higher resource prices

Saudi Arabia

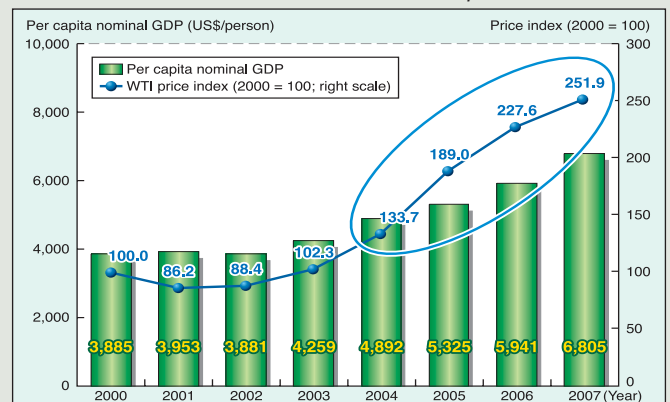
Trends in Saudi Arabia's nominal GDP & oil price index



Source : World Economic Outlook Database (April 2008), IMF

Russia

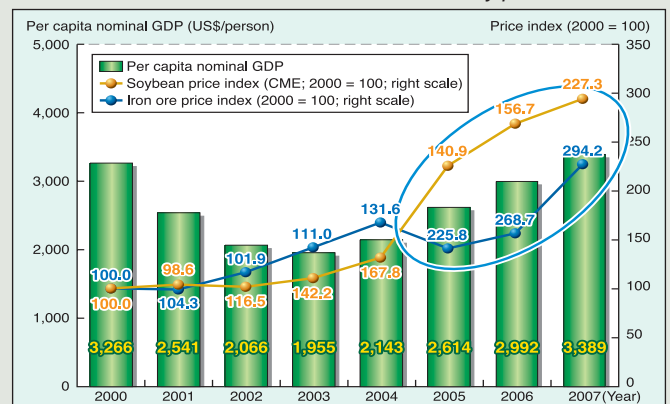
Trends in Russia's nominal GDP & oil price index



Source : World Economic Outlook Database (April 2008), IMF

Brazil

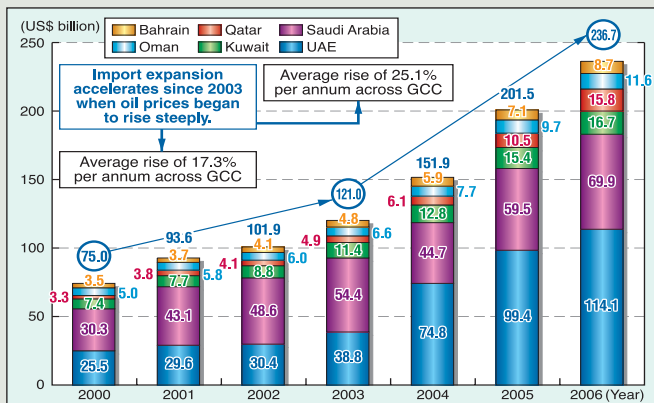
Trends in Brazil's nominal GDP & commodity price index



Source : World Economic Outlook Database (April 2008), IMF

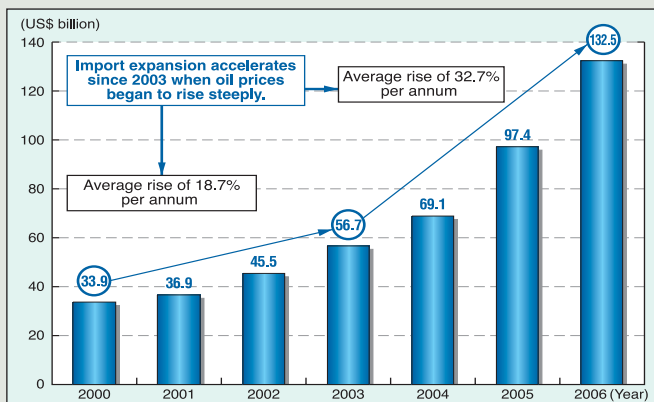
bolster resource-rich countries

Trends in import value of GCC countries



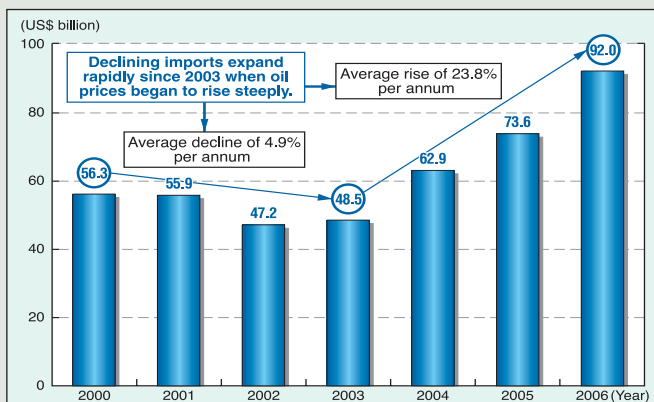
Source : Direction of Trade Statistics, IMF

Trends in Russia's import value



Source : Direction of Trade Statistics, IMF

Trends in Brazil's import value



Source : Direction of Trade Statistics, IMF

2. Creation of "Greater Asian Market" Driving New World Economic Development

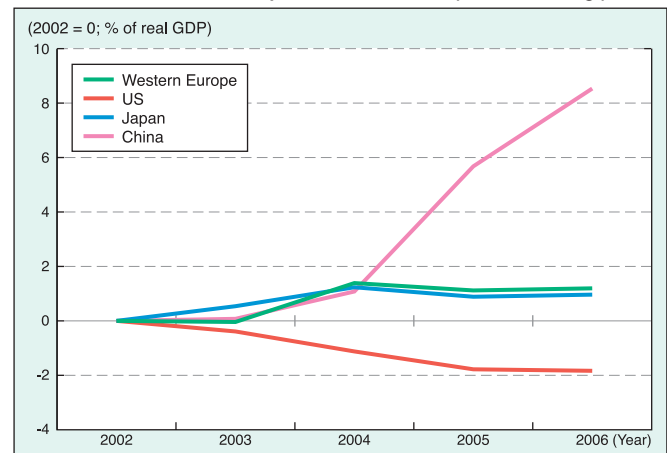
For Japan to strengthen its linkage with the "five billion-person market," we must first look to further strengthening Japan's ties with Asia, with which Japan has a deep economic involvement, and building a base for global expansion with Asia as the axis.

Factors such as direct investment from Japanese industry have seen Asia evolve into a world growth center, where rising income levels are creating a consumer population with the same tastes as Japanese consumers (*Chart 7*). Japan and Asia together account for three billion people, and as such, the region has strong development potential as a major consumer market. Asia presents both a number of unique economic development patterns — China as the world's factory, for example, and India as the world's IT base — and affluent and diverse human capital. Combination of these management resources should produce Asia-generated knowledge creation.

These two elements — firstly, the formation of an Asian consumer population that shares Japanese consumer tastes and the creation of a major consumption center, and secondly, combination of the unique management resources of the various Asian countries to form a knowledge-creation

Chart 6 Countries exporting to resource-rich countries reabsorb wealth through exports

Trends in total value of major countries' net exports & trading profits



Note : Western Europe here is as designated in UN statistics, including Austria, Belgium, Germany, Lichtenstein, Luxembourg, Monaco, the Netherlands and Switzerland.

Sources : World Development Indicators, World Bank; National Accounts Main Aggregates Database, United Nations

* Trading profits' here denote the actual value of income arising from the difference between import and export prices (deflator), and reflects changes in the trading environment. Trading profits = (nominal exports - nominal imports)/numerical deflator + (nominal exports/export deflator - nominal imports/import deflator)

* Numerical deflator = (nominal exports + nominal imports)/(real exports + real imports)

* All data represent the degree of change since 2002 (when the current oil price surge began).

center that generates new knowledge — will bind Asia together as a value-creation center and create a base for endogenous development. This framework will be underpinned by the network of economic partnership agreements emerging in Asia with ASEAN as the hub. The 2008 White Paper refers to this new Asian growth zone as the “greater Asian market.”

3. Creation of “Market for Sustainable Development” that Addresses Global Issues

(1) Common issues that need to be resolved to progress sustainable development

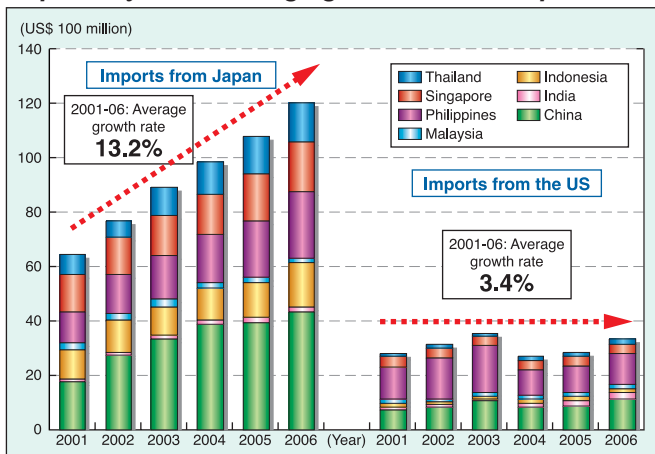
The sustainable development of the “five billion-person market” will hinge on addressing common challenges, namely the aforementioned resource constraints that have been brought to prominence by surging resource and food prices, as well as environmental constraints, urbanization, the graying of society, and natural disasters (*Charts 8, 9 & 10*).

Other global challenges, which could be described as the “dark side” of globalization, include assisting the billion-strong poor who stand outside this tide of economic development, the new infectious diseases, and the frequent natural disasters accompanying climate change.

(2) Japanese know-how valuable in resolving common issues

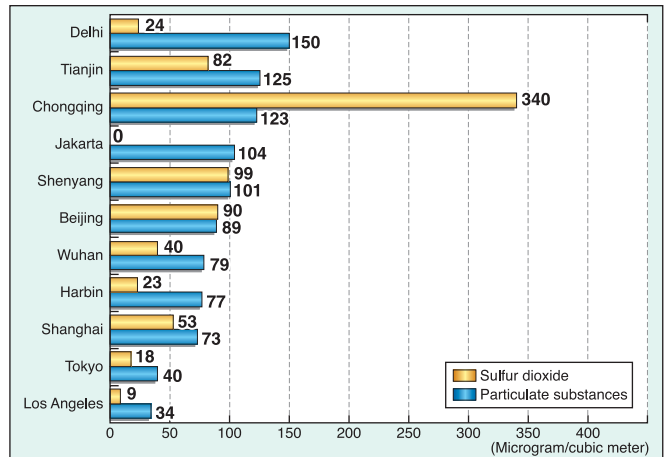
The above challenges have all been faced by Japan ahead of Asia in the course of Japan’s modern economic development, and have seen active Japanese efforts to overcome them. Naturally, there are also issues such as climate change which Japan continues to address proactively. In the course of its efforts, Japan has built up a

Chart 7 Trends in the value of consumer goods imports by Asian emerging markets from Japan & US



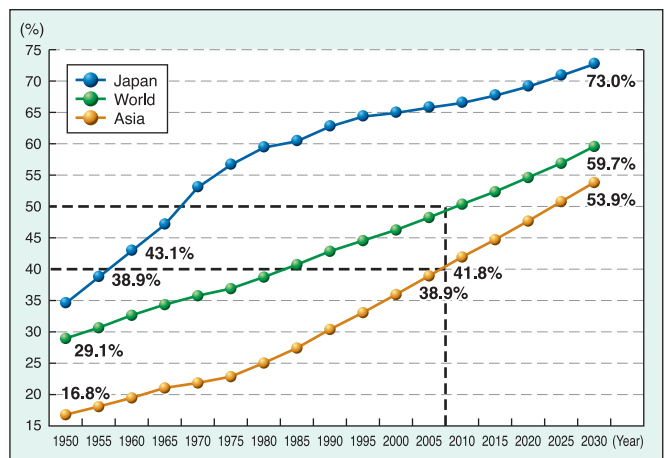
Source : RIETI-TID 2007

Chart 8 Air pollution in major cities in China, India, Japan & US



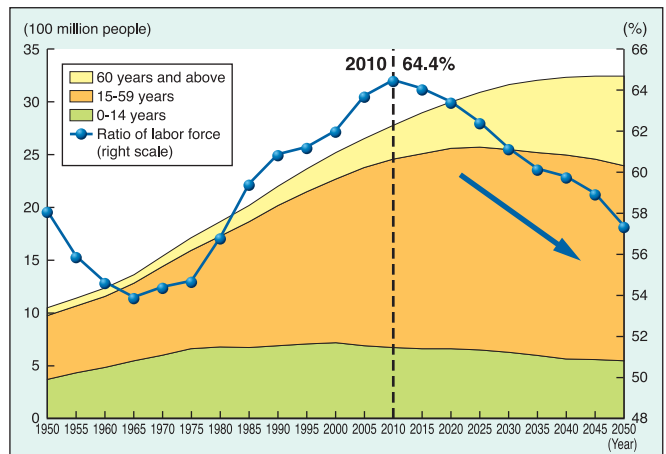
Source : UNESCO

Chart 9 Trends in urbanization rates in Japan & East Asia



Source : World Urbanization Prospects: 2007 Revised Database, United Nations

Chart 10 Trends in labor force rate in Asia



Source : World Population Prospects, United Nations

number of advanced technologies and social systems specifically designed to respond to these challenges. In other words, a system of innovation has evolved in Japan whereby various techniques and know-how created by human capital are then refined and combined to produce solutions.

For example, the experience of the two oil crises in the 1970s has led Japan to foster energy-saving technology and other industrial technologies and to promote innovative technology development. Japan has also addressed the autonomous development and recycling of resources, as well as nurturing outstanding technologies for alternative fuel development. Then there is Japan's water resource management system, designed in response to the 1970s pollution problems to conserve water and be environmentally friendly. What we should be attempting now is to transfer these technologies and social systems to East Asia to build an Asian development model that will take Asia to the forefront in addressing such challenges. The same model can then be extended into a development model for resolving global issues.

It is Japan's historical mission to contribute to both resolving challenges and promoting economic growth by assisting Asia in adopting those systems and technologies emerging from Japanese experience and in promoting new innovation. However, to realize new innovation, conditions and opportunities need to be provided to promote economic activities that engage a diverse range of players in resolving common challenges, building these activities into the social structure as a new economic area (a "market for sustainable development").

This "market for sustainable development" is highly likely to provide numerous business opportunities for Japanese firms (Chart 11). We hope to see Japanese companies actively exploring the new market, thereby contributing to the sustainable development of the world economy (Chart 12).

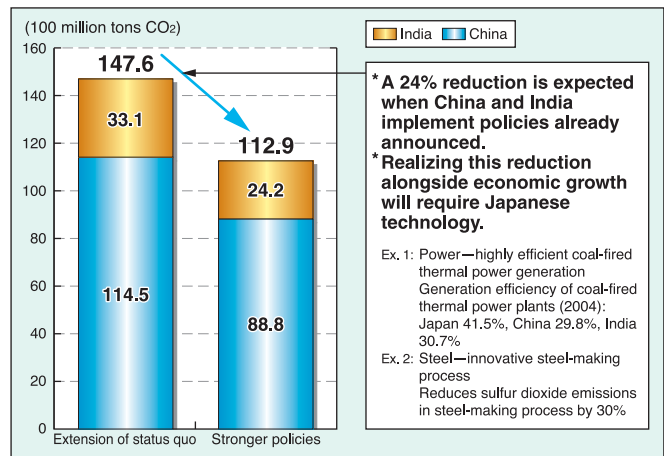
4. Building a Global Strategy to Lead Sustainable Development

Thus far we have confirmed that taking the Japanese economy forward in the midst of world economic globalization will require the creation of three markets: a "five billion-person market," a "greater Asian market," and a "market for sustainable development."

To capture these markets, Japan must lay out a course of action — a global strategy.

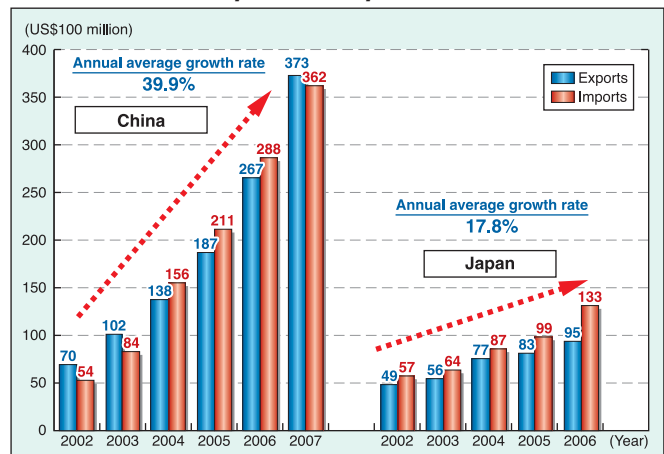
Looking at the current situation in Japan, Japanese firms are proactively developing business with those resource-rich countries that have benefited from the recent high resource prices, bringing back wealth that has flowed outwards. As

Chart 11 Energy-based sulfur dioxide emissions in 2030



Source : World Energy Outlook 2007, IEA

Chart 12 Trends in the value of Japanese and Chinese exports to/imports from Africa



Source : Created from CEIC database & JETRO website

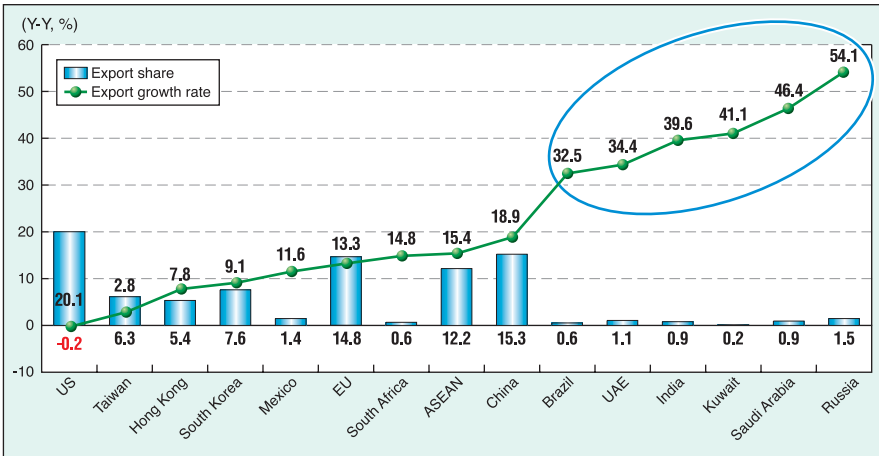
such, Japan appears to be developing a more robust economic constitution than it has evinced during the previous periods of high resource prices (Charts 13 & 14).

What Japan needs at this point are external policies that will build an economic structure which turns global economic risks into opportunities, and then boosts the robustness of that structure.

To strengthen access to the world economy to that end, Japan can: (a) promote the WTO Doha round of negotiations, and (b) actively conclude free trade agreements (FTAs) and economic partnership agreements (EPAs).

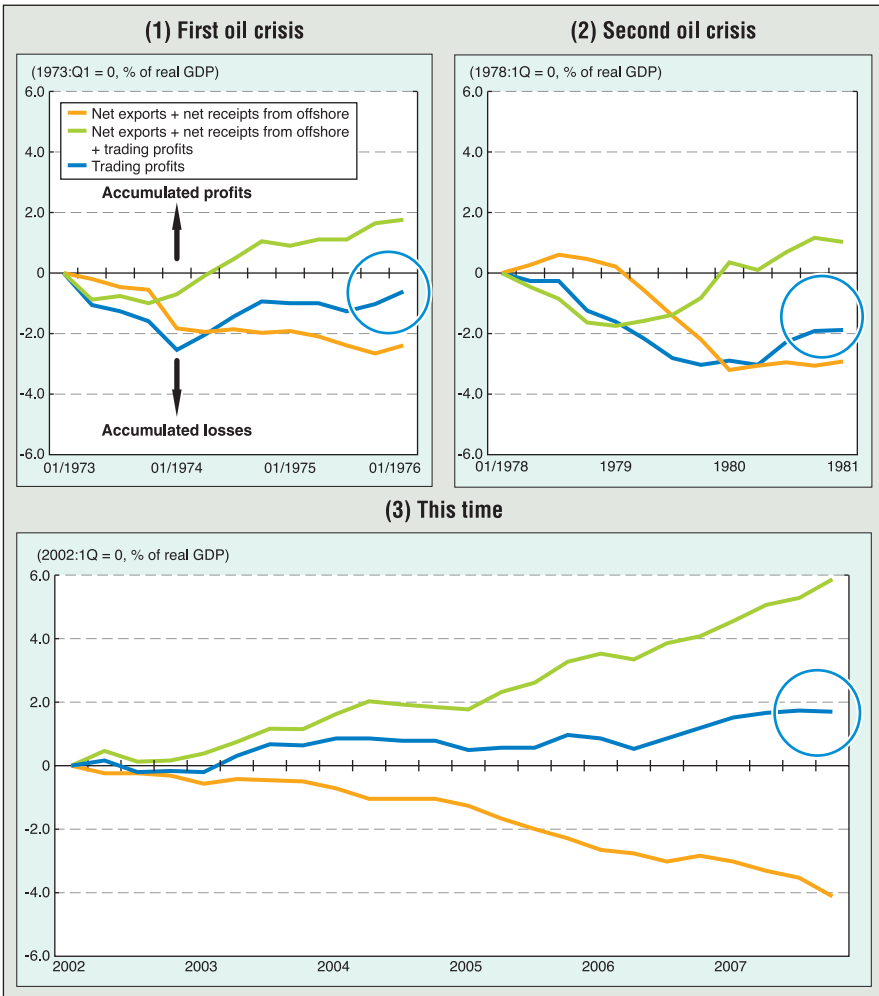
Looking at (a), the Doha negotiations should lower member-country tariffs across the board and open markets simultaneously across the world. In addition to its

Chart 13 Japanese exports to resource-rich countries growing sharply
 Japan's export share by destination & growth rate (2007)



Source : Trade Statistics, Ministry of Finance

Chart 14 Net export growth covers worsening terms of trade



Source : Outlook for Economic Activity & Prices (April 2008), Bank of Japan

negotiation function, the WTO also has a dispute settlement mechanism. Japan needs to make proactive use of the WTO and its various functions.

Turning to (b), Japan needs to use FTAs and EPAs to strengthen its links with other countries at a higher level of discipline than in the WTO. Countries around the world have pursued active EPA/FTA strategies since the 1990s, and Japan too has actively concluded agreements with ASEAN members in particular. In addition to trade, foreign direct investment (FDI) too is an effective tool. Japan must improve the offshore investment environment through instruments such as investment treaties to help Japanese firms expand their offshore operations. At the same time, improving the offshore investment environment also requires improving the Japanese business environment for foreign firms entering our market. In other words, the conditions need to be set in place to facilitate the flow of investment both into and out of Japan.

Bringing these external policies together is “the Concept of an Asian Economic and Environmental Community,” which is a new development strategy for Japan and Asia. In this concept, Japan aims to “contribute to Asia, and grow with Asia” with its technologies and social systems that Japan has developed through its front-running efforts to address environmental and resource constraints, urbanization and the graying of society – issues which have now become common challenges in the sustainable development of the Asian region. JS