Global Economic Crisis Lifts Japan to New Heights

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The Ministry of International Trade and Industry or MITI (now the Ministry of Economy, Trade and Industry or METI) was founded in May 1949. MITI published its first "White Paper on International Economy and Trade" three months later, on August 15 that year, the fourth anniversary of the end of World War II. The paper declared both at home and to the rest of the world that Japan will live as a peaceful trading nation. This sort of document has been published annually since then, the latest edition being the 61st.

The White Paper on International Economy and Trade 2009 analyzes the ongoing historic global economic crisis and presents the course of economic policies to be pursued by Japan to "change a pinch into a chance."

1. It reviews how the financial crisis that began in the United States in September 2008 spread to the rest of the world and brought a serious impact on the actual economic activities of individual countries in a short period, and looks into conditions that would bring the crisis to an end. It also focuses on the Asian economy as a potential engine to drive world economic growth.
2. It also analyzes the impact of the global economic crisis on the Japanese economy and underlines the importance to: (1) encourage the growth of emerging economies and resource-rich countries, in particular the middle-class Asian markets, (2) further promote innovation and globalization, and emphasize Japan's attractive points to the rest of the world, and (3) guard against protectionism and uphold the free trade system.
3. It features Japan's traditional human-centered capitalism as against financial capitalism and showcases a new model for public-private collaboration.

1. Factors behind Expansion of US Housing Loan Market

It is beyond discussion that the expansion of the US housing market was one of factors behind the latest financial crisis. Unabated growth of the market lay behind the debut of new financial products such as subprime mortgages, greater willingness of investors to increase exposure to riskier assets, the assignment by credit-rating agencies of high ratings to mortgage-backed securities and their resecuritized instruments and financial institutions' obsession with the securitization business. The mutual trust among market participants such as home owners, financial investors, rating agencies and banks had been supported by the sustained market expansion. It faltered when US housing prices crashed. The process went on developing into global financial woes.

This article sorts out the factors that inflated the US housing market and discusses how they are relevant in devising longer-term measures for crisis control, including ways to prevent a recurrence of the ongoing crisis.

(1) US Mortgage Securitization Market Grows Rapidly

The size of the US housing market was approximately $10 trillion (1,200 trillion yen at the exchange rate at the end of 2006) in terms of housing loans outstanding, about seven times as much as the Japanese market (which totaled 180 trillion yen at the end of 2005), and roughly $2.8 trillion (336 trillion yen) in terms of new loans, 15 times as much as Japan's (23 trillion yen). As the housing market ballooned, housing prices that rose 3.5% per year on the average in the 1990s surged 7.2% annually after 2000. The rate of growth reached 9.4% at its peak in 2005.

The US housing market explosion was financially supported by a huge volume of funds procured both inside and outside the United States through the mortgage securitization market.

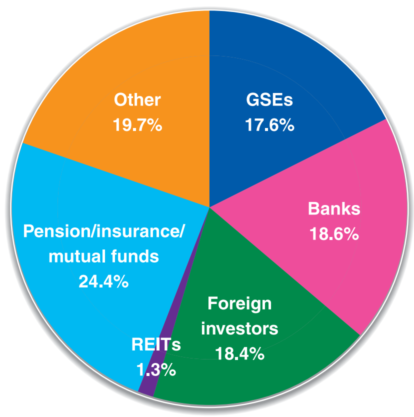
The US residential mortgage-backed security (RMBS) market is about 60 times as big as the Japanese market. The amount of RMBS issued annually in the United States reaches a level equivalent to around 80% of new loans (about 20% in Japan). As of January 2006, 63% of the amount of residential mortgages outstanding had been securitized.

These securitized mortgages were sold to many investors across the world. This meant that the US mortgage market was supported by investment funds that flowed into it from both at home and abroad. The biggest investors were US pension funds, insurance companies and mutual funds, which together accounted for 24.4% of the total amount of mortgages outstanding. They were followed by US banks, government-sponsored enterprises (GSEs) and foreign investors, which accounted for around 18% each *(Chart 1)*.

CHART 1

Primary investors in US mortgage-related securities

$6.6 trillion (as of mid-2007)



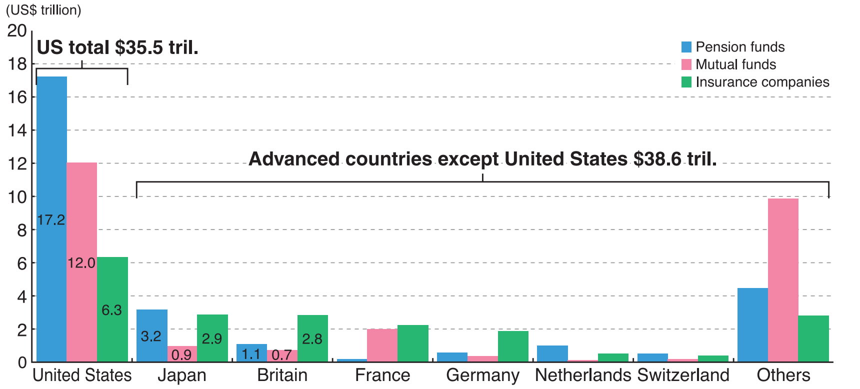
Source: "Global Financial Stability Report," October 2008, IMF

(2) Influx of Pension, Insurance & Mutual Funds

Institutional investors such as pension funds, insurance companies and mutual funds in the United States and other advanced economies played a key role in the expansion of the US mortgage market. These investors have an enormous volume of money to manage that accounts for the bulk of the world's total investment funds. Development of their global investment policy has an immense impact on the price trends of equities, debt securities and other financial assets across the world *(Chart 2)*.

CHART 3

Funds held by pension funds/insurance companies/ mutual funds in advanced countries (as of the end of 2007)



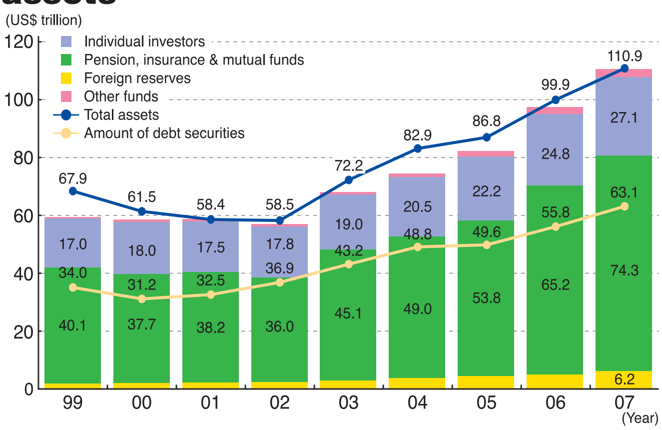
Source: International Financial Services, London, & CBS Fund Management 2003-2008

Notably, an overwhelming portion of the money comes from pension funds, insurance companies and mutual funds which are committed to managing their funds in a long-term, stable manner. Such funds are amassed primarily in advanced countries where social security systems and financial markets are well organized. They grew quickly in volume after 2003, keeping pace with progress in population aging and the spread of a defined contribution pension system in the advanced economies. Their outstanding volume came to $74.3 trillion at the end of 2007, more than double the amount at the end of 2002 ($36.0 trillion). The funds gathered by pension funds, insurance companies and mutual funds at the end of 2007 were 2.7 times those of individual investors, 11.9 times the world's total foreign exchange reserves and 27.1 times those of other financial investors including hedge funds and private equity funds.

Financial assets also began swelling in volume in 2003. While corporate debt securities grew slower than funds held by institutional investors, the total market value of equity securities (the total amount of assets outstanding minus the amount of debt securities outstanding in *Chart 2*) expanded rapidly in a way bridging the gap.

CHART 2

Global investment funds & financial assets



Note: 1. Total assets are the sum of outstanding debt securities and market value of equities.
2. Foreign reserves exclude gold. Other funds are the sum of private equity/hedge funds.
3. Assets (debt securities/equities) are the sum of those in the United States, Canada, Britain, France, Germany, Italy, the Netherlands, Switzerland, Japan, Australia, Singapore and Hong Kong.
4. Funds held by pension funds/insurance companies/mutual funds and individual investors and "other funds" comprise mainly those in advanced countries and do not include those in emerging economies.

Source: International Financial Services, London, & CBS Fund Management 2003-2008

The chart illustrates how the enlarged volume of funds managed by institutional investors in advanced countries boosted global demand for financial assets and inflated the world's equity and debt securities markets where such funds are primarily invested.

Several factors prompted pension funds, insurance companies and mutual funds to place huge amounts of their funds in mortgage-backed securities. First, funds held by them swelled in volume on a global scale in recent years. Second, the extremely long period of pension and insurance liabilities inevitably prodded their fund managers to put the money in sound assets that yield stable returns over a long period. Third, the US housing market kept growing steadily amid the increasing population brought in part by the influx of immigrants, thus making constant principal and interest revenues from the market available to these institutional investors for as long as 30 years and precisely matching their needs. Fourth, the development of the RMBS market in the United States gave those institutional investors easy access to claims arising from US housing loans.

The global scale of funds collected by pension funds, insurance companies and mutual funds barely totaled $36 trillion in 1999. It kept expanding steadily after 2003, reaching more than $74 trillion at the end of 2007. The size of such funds in the United States almost equaled the combined amount of such funds in other advanced countries – $38.6 trillion *(Chart 3)*.

A sizable portion of the global liquidity in excess of $70 trillion flowed into the US RMBS market, barely one-10th in scale. This is considered one of the major factors that sent the US housing market overheating.

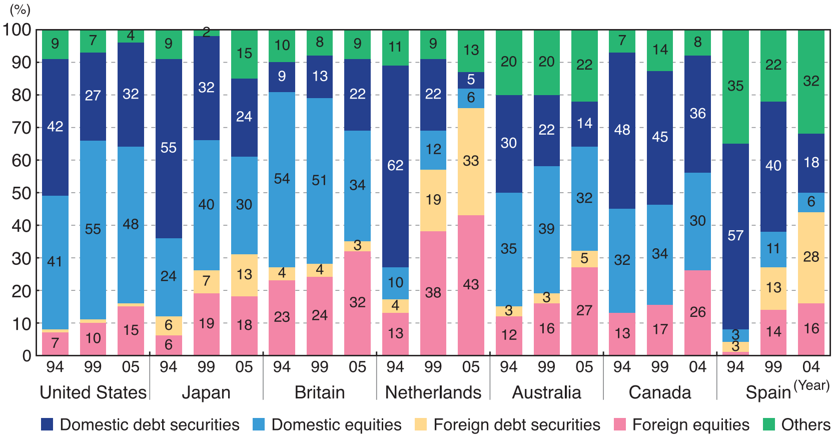
(3) United States as Supplier of Sound Assets

What are the factors that kept such a huge amount of money flowing into the US housing market for such a prolonged period?

Amid the progress of population aging, financial assets held by individuals and pension funds have grown markedly in volume in the United States and other advanced economies. Individual assets and

CHART 4

Pension fund asset allocations in selected countries (% of pension fund portfolios)



Source: "Global Financial Stability Report," April 2007, IMF

foreign exchange reserves have also kept swelling in emerging economies, notably China and oil-producing countries in the Middle East, amid rapid economic growth and the past upsurge of commodity prices.

These funds trot about across the world in search of financial instruments that suit their different management strategies. For instance, pension funds and insurance companies are required to meet their liabilities for pension benefit or insurance payment steadily over a long period. They are in need of assets that will yield stable, long-term returns.

In contrast, hedge funds are in need of assets that will bring high returns in a short period. Foreign exchange reserves, which are required to retain their security and liquidity, need to find risk-free foreign currency-denominated assets as store-of-value instruments.

The advanced financial technologies and the progress of financial deregulations in various countries have enabled institutional investors to manage their funds outside their home markets. Some facts strongly suggest that the Unites States is the only country that can provide sound financial assets needed by those funds. For instance, the ratio of US pension funds' investment in foreign securities is strikingly lower than those of pension funds in other countries *(Chart 4)*. In addition, the amount of foreign investment in US securities outstanding is prominently higher than those in other countries and regions.

(4) Summary

As seen above, the expansion of the US housing market that triggered the global financial crisis stemmed from two structural factors. One is the rapid growth of funds for portfolio investment such as those of pension funds/insurance companies/mutual funds and individual investors and foreign exchange reserves, brought about by the progress of population aging in the United States and other advanced countries and the high economic growth in emerging countries. The other factor is a global short supply of sound assets indispensable for the management of the huge amounts of funds.

The global shortage in the supply of sound assets, coupled with the dollar's attractiveness as an international settlement currency, brought about concentrated investment in the United States, the sole massive supplier of sound assets *(Chart 5)*. This inflated the prices of assets in what was known as IT stock and housing bubbles.

Behind the outbreak of the global crisis was a rush of investment focused on US assets amid the short supply of sound assets. Given this background, introducing tighter regulations on financial intermediaries and securitized products and enhancing greater transparency of information on financial derivatives should be included in anti-crisis measures to be taken immediately. In a longer term, measures to expand the global supply of sound assets are indispensable as sweeping anti-crisis steps, including those to prevent a recurrence of the crisis.

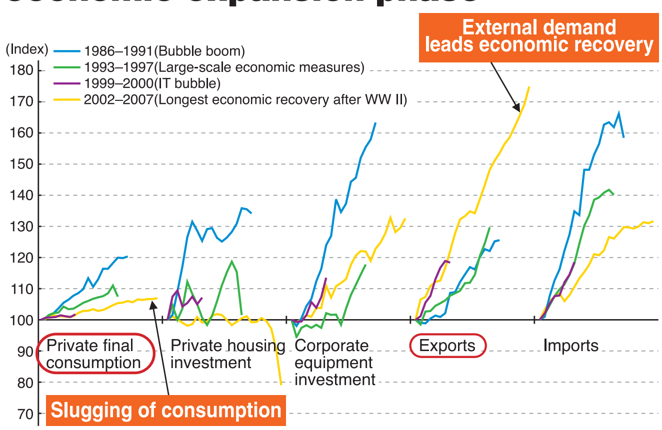
2. Global Economic Crisis & Course of Action to Be Pursued by Japan

The Japanese economy began picking up in January 2002. The recovery phase lasted 69 months through October 2007, the longest uninterrupted growth in the country's postwar history. The rally was led by exports, which grew at a pace unseen during any of the past recovery phases. But on the demand side, private final consumption, which accounts for nearly 60% of gross national income (GNI), and other domestic expenditures grew at a sluggish pace *(Chart 6)*.

In that situation, a financial crisis surfaced in the United States in September 2008. Japanese exports began nosediving in October that year, plunging 49.4% on year in February 2009 for the steepest fall since 1980, when the last comparable tallies were available. As exports slumped, the Japanese economy shrank 14.4% in the third

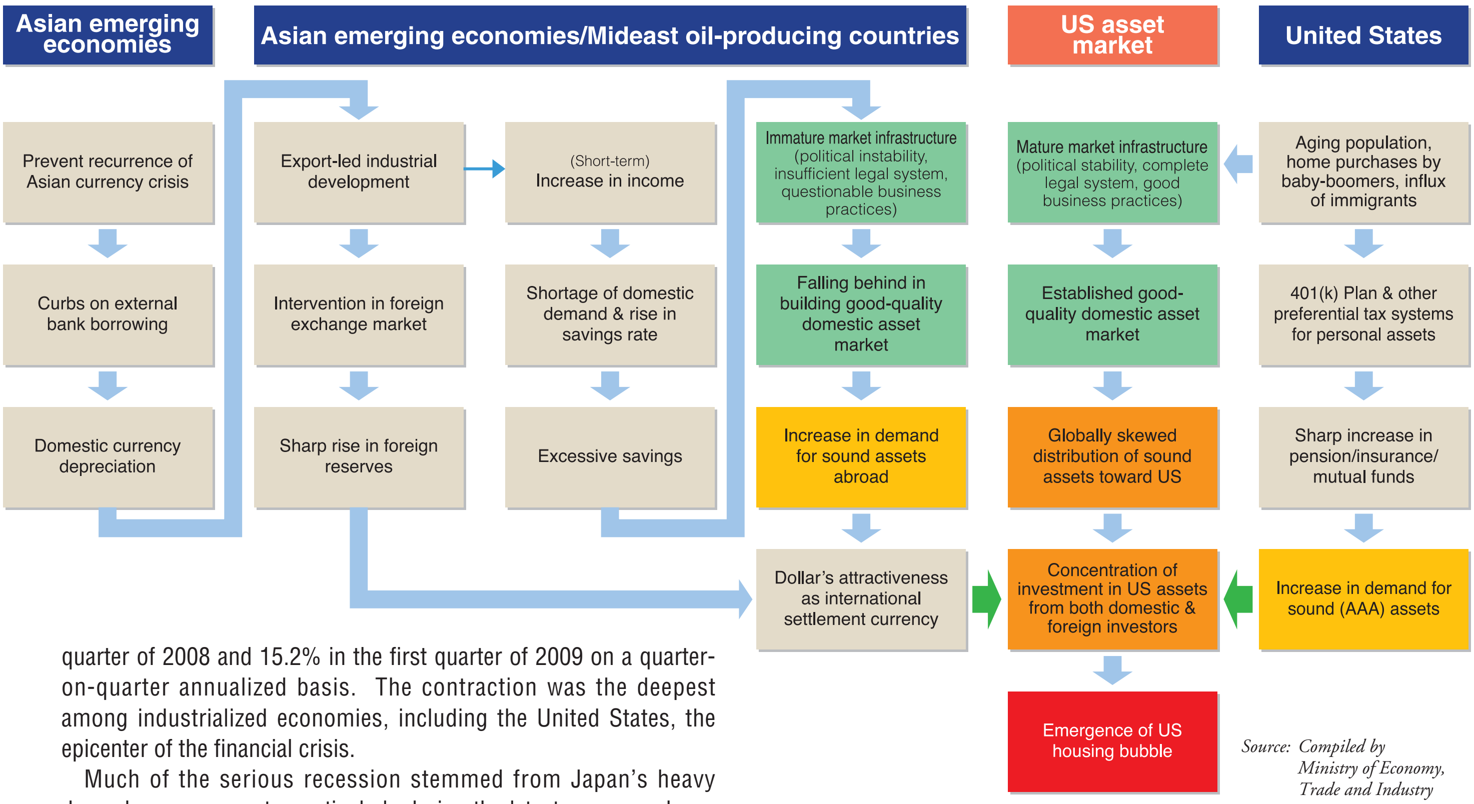
CHART 6

Comparison of recovery trends of demand components in Japan's economic expansion phase



Note: Figure of each first quarter was indexed as 100.
Source: SNA (National Accounts of Japan), Cabinet Office, Government of Japan

CHART 5
How US housing bubble emerged



Source: Compiled by Ministry of Economy, Trade and Industry

quarter of 2008 and 15.2% in the first quarter of 2009 on a quarter-on-quarter annualized basis. The contraction was the deepest among industrialized economies, including the United States, the epicenter of the financial crisis.

Much of the serious recession stemmed from Japan's heavy dependence on exports, particularly during the latest recovery phase. A look into their structure in detail shows Japanese exports are characterized by (1) their excessive dependence on the US market, including indirect exports via other Asian countries (products assembled there from parts and components supplied from Japan for shipments to Europe and the United States) and (2) the export industry's concentration on cars, electrical appliances and general machinery that have a greater impact on production by other domestic industries.

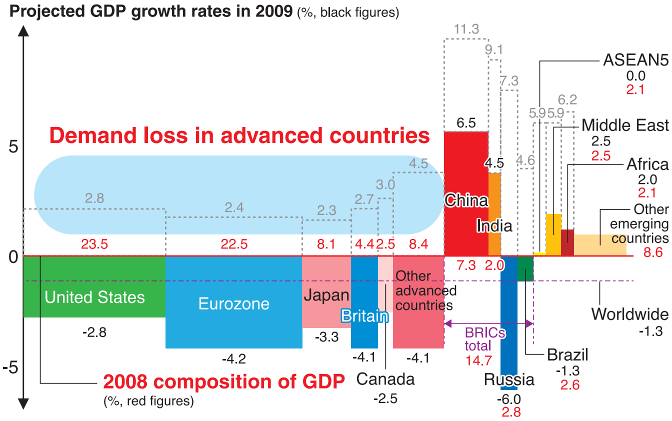
Given this export structure, Japan needs to review final destinations of its exports concentrated on the United States and Europe as well as individual export items and diversify its export markets to attain sustained economic growth over a medium to long term. Additionally, further expansion of foreign direct investment will be an effective means to diversify sources of its economic growth.

Promising destinations of Japanese exports and direct investment are the Asian economic bloc and other emerging economics, where middle-class populations have been rapidly expanding and fast economic growth is expected to continue after the current global financial crisis *(Chart 7)*. But those emerging markets are exposed to fierce competition from China and South Korea and thus product development, procurement of local goods and recruitment of local staff hold the key.

Another challenge in seeking to exploit the emerging economies is how to develop a volume (middle-class) market in addition to the high-end market, the main business turf for companies from advanced countries. Japan has excellent technologies and unique culture. It can be successful in exploring new business opportunities by sending them out and appealing for its attractive points to the rest of the world. Introduced below are examples of Japanese businesses taking on such challenges.

CHART 7
GDP composition by country/region & economic growth outlook

Projected GDP growth rates in 2009 (%, black figures)

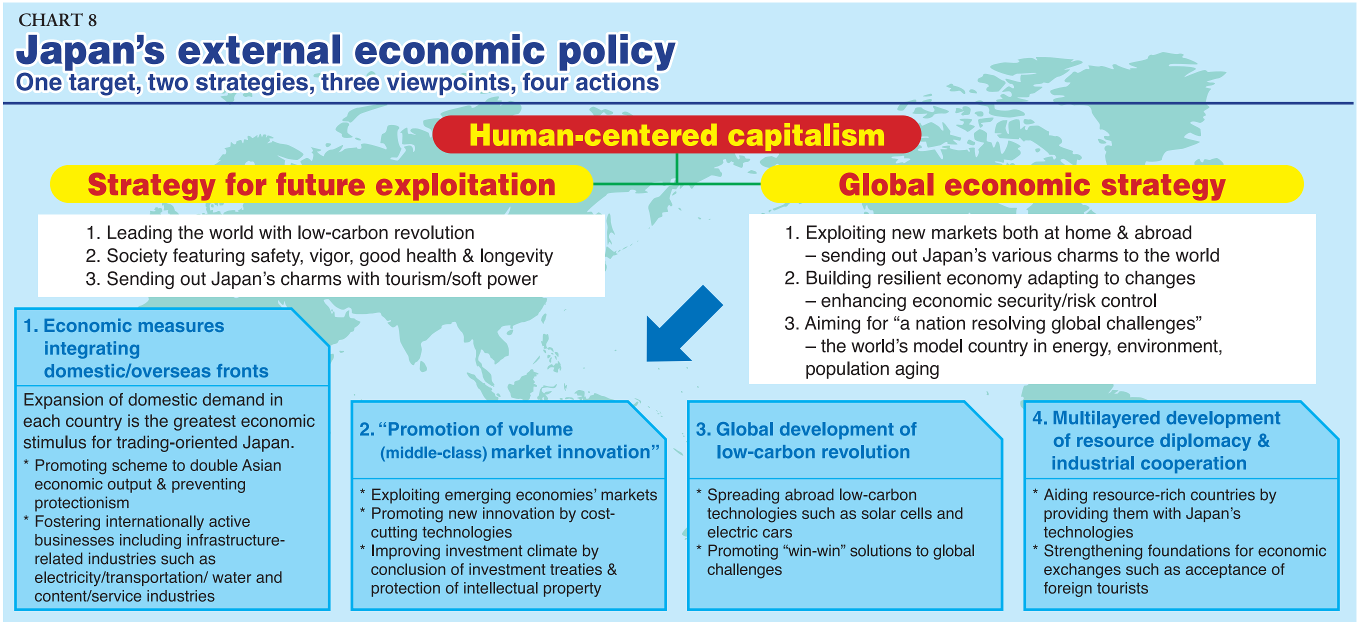


Note: Dot lines show annual average growth rates in 2003 – 2007.

Source: "World Economic Outlook," April 2009, IMF, and Japanese Economic Outlook by Cabinet Office, Government of Japan

Case 1: Exporting fresh squid through fishery-engineering partnership

The town of Ama is on the Nakanoshima islet of the Oki Islands in the Sea of Japan, about 60 km off Shimane Prefecture. It has been faced for years with constant depopulation and a falling birthrate. With a population of 2,400, it has only around 10 new babies each



Source: Ministry of Economy, Trade and Industry

year. Being on an isolated islet, Ama has been unable to merge with other towns and villages to become bigger. State fiscal aid has been on the constant decline, with the local industry and economy left to wane visibly.

A group of islanders founded their company, Furusato (hometown) Ama, in 2005 to earn "foreign currency" from the mainland by utilizing natural resources in the area. The firm, capitalized at 250 million yen and with 10 employees, aims to create more jobs by developing and marketing agricultural, fishery and forestry products.

The Oki Islands area, designated as a national park, offers good fishing grounds and was known as *Shoku-no-kuni* or *Miketsu-kuni* (land of food) that contributed shells and shellfish to the imperial court in ancient days. It takes two hours by high-speed ferry to travel from Ama to the nearest point on the mainland. The distance was a big obstacle in shipping fish and shellfish caught in the area in as fresh a condition as when eaten by the islanders. The company cleared the problem by employing new freezing technology.

The epochal CAS technology was developed by ABI Co., a venture business based in Abiko, Chiba Prefecture. The company named it a "cells alive system (CAS)" as it does not destroy cells in the freezing process and retains the freshness of a product when it is unfrozen. ABI has obtained patents on the technology in more than 10 countries and is engaged in related joint research projects with domestic and overseas colleges and research institutes in more than 30 countries. During his visit to the company on May 9, Prime Minister Taro Aso lauded the new invention, saying, "With this technology, agriculture and fishery can change into new growth industries."

Furusato Ama has commercialized local marine products such as oysters, white squid *(Loligo edulis),* turban shell and sea bream using CAS. The products have become available at convenience stores and mail-order companies throughout the country from Hokkaido to the north to Miyako Island to the south. The company directly ships frozen white squid to Shanghai. It has received inquires about the product from Dubai. The unique freezing technology has now put Japan's marine resources closer to the rest of the world. Furusato Ama sends out local information via its blog, which it says has found numerous regular readers.

Photos: Furusato Ama

Case 2: New product development by Kumakura Garasu Kogei

Edo *kiriko* (cut glass), which dates back to 1834, is popular among foreign tourists for its gorgeous design and exquisite cuts. Kumakura Garasu Kogei, a small glass workshop in Tokyo's Koto Ward, has developed a variety of unique products by combining the traditional *kiriko* technology with both new and old patterns *(photos)*. Many tourists, mainly from Europe and Asia, visit its workshop-cum-showroom every day. The company leases a parking lot from a nearby *Shinto* shrine, and a routine tour for visitors includes a lecture on *Shinto's* history by a priest and a guide to the shrine's warehouse storing *mikoshi* (portable shrine), which is usually closed to the public. The tour attracts foreign tourists as it helps bring them deeper into the sentiment of the Edo era (1603-1867).

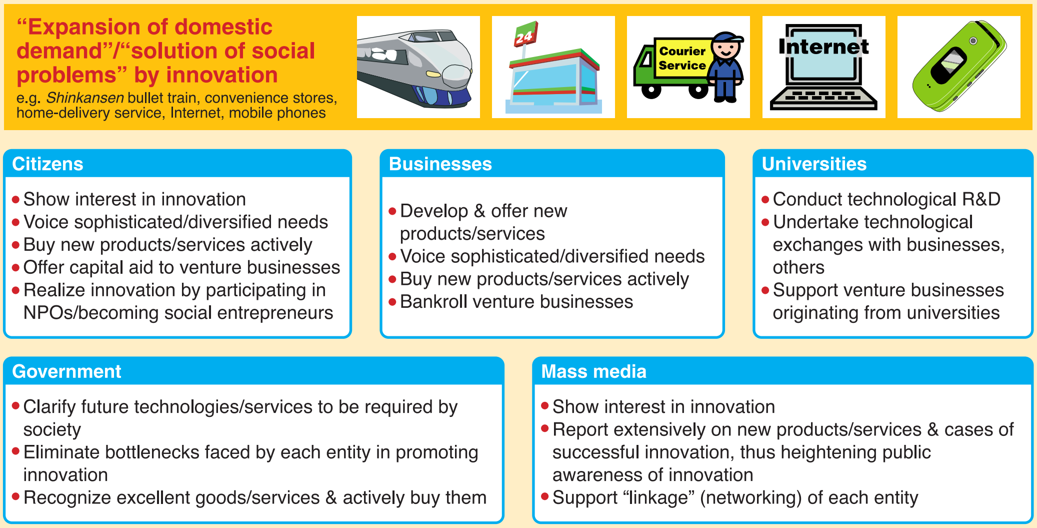
Right now, Kumakura is working on a project to develop new products by adding value to the Edo *kiriko* technique through its combination with other traditional Japanese artifacts. It is keen to send out information on these products to the rest of the world. The company first focused on a lamp as a product that can find a market throughout the world. It has come up with a product combining Edo *kiriko* with the traditional copperware from

Photos: Kumakura Garasu Kogei

An original pattern prepared by Kumakura (left) and a lamp combining "Edo kiriko" cut glass with traditional copperware from Takaoka, Toyama Prefecture (right)

CHART 9

Example of new gov't/private cooperation Promotion of innovation



Source: Ministry of Economy, Trade and Industry

Takaoka, Toyama Prefecture. Its shade is made of Edo *kiriko* and its stand is based on the copperware technique *(photo)*. The lamps retail for hundreds of thousands of yen (thousands of dollars) each. Although unveiled only in 2008, it has been bought by some foreign fanciers. Foreign importers have offered to market the lamp in their countries. Some wealthy foreigners reportedly visit Japan for the sole purpose of buying the company's products after being satisfied with a Kumakura lamp – though far from inexpensive – given as a souvenir by acquaintances. Kumakura is now planning to develop other "made in Japan" products that incorporate the essence of traditional craftsmanship Japan is proud of, such as Arita ware, *washi* (Japanese paper), dyed goods and woodwork, in partnership with companies in different business lines.

3. Japan's Global Economic Strategy

Japan, too, has taken a battering from the impact of the US-originating global financial crisis that engulfed the rest of the world. However, this is not the first time that Japan has experienced a crisis of this dimension. It pulled through two national crises – "the end of national isolation and the Meiji Restoration (141 years ago)" and "the defeat in the war and postwar reforms (64 years ago)." It weathered less severe crises in later years, among them the "Nixon shock" (brought by then US President Richard Nixon's decision to devaluate the US dollar), the oil crises and the Plaza Accord that led to the yen's steep appreciation. This time around, Japan will make the most of the lessons it learned from the "worst financial/economic crisis in a century" to transform its industrial structure and build a more resilient economy.

(1) Being Caught Up & Overtaken – Japan's First Experience

Japan is now going through a period of being caught up and overtaken, the same phenomenon the United States and Europe experienced from the 1970s through the 1980s. In such an era, Japan cannot wage price competition by manufacturing products quite similar to those made in countries where cheaper labor is readily available. The key is differentiation – whether it can generate goods and services that cannot be turned out in those countries. Japan's future depends on whether it can constantly put out goods and services of the world's highest quality or creative and unique products/services that other countries cannot imitate.

(2) What Japan Should Aim for – One Target, Two Strategies, Three Viewpoints, Four Actions

For a Japan faced with a rapidly aging population and a steadily falling birthrate, human capital is the most valuable resource it can rely on. Money that ought to have been a means to seek happiness has turned into an end itself in today's society where finance appears to be considered almighty. As a strategic idea that can counter the trend, Japan should send out to the world what might be called a "human-centered" economy or "human-centered capitalism." Japan is the sole country in the world that has experiences and records of corporate and social management based on "human-centered capitalism." Japan should challenge itself to realizing three objectives – a society that best takes care of its people in the world, a society where one can bring out all of one's skills and abilities and participate in innovation activities, and a society where one can find one's life worthwhile.

(3) Establishing "Social Medicine" Resolving Social Problems

The power of science has enabled mankind to overcome tuberculosis and smallpox, expand agricultural production and travel into the space. However, science has not progressed adequately enough to cure "social diseases" such as war and poverty. Society is a complicated system and solution of issues it faces is not easy. Japan needs to establish as quickly as possible a means of management for solutions or "social medicine" that can help cure social diseases by elaborately analyzing cases of success and failure. Not only the government but various entities in society need to participate in solving social issues. JS