World Economy & Policy Issues after Financial Crisis

By Shin-ichi FUKUDA

1. Once-in-a-Century Crisis

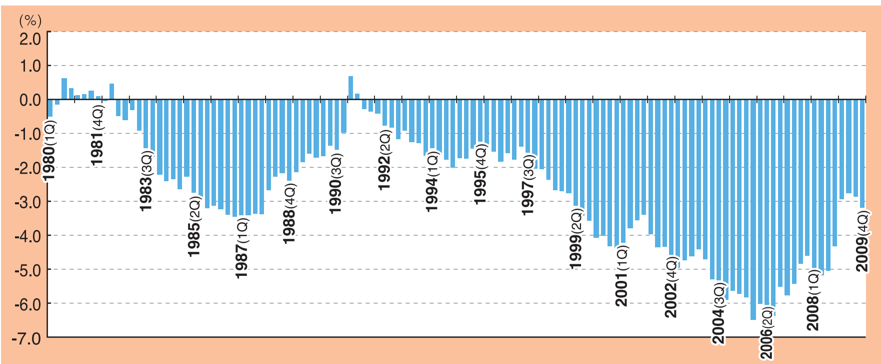
Since last year, the world economy has finally managed to start rebounding from turmoil caused by what was dubbed a "once-in-a-century financial *tsunami,*" accompanied by a serious global recession. It is now generally acknowledged that the world economy has extricated itself out of the worst state although various unstable factors still persist. Nevertheless, we still find ourselves in a trial-and-error stage as to how to transform the structural paradigm of the post-crisis world economy and what should be followed from now on in order to achieve sustainable economic growth.

The direct cause of the great shock that hit the world economy from the summer of 2007 was a precipitate fall in asset prices, especially in the United States, and the consequent instability of the financial system. In the background, however, were such grave developments as excessively limited savings and extravagant consumption in the United States, and the global imbalance in capital flows. As shown in *Chart 1,* the US current account, though continuously in deficit from the first half of the 1980s, registered an average 2% of gross domestic product (GDP) until the mid-1990s and could be barely covered by surpluses in other developed countries like Japan and Germany. However, from the late 1990s, the US current account deficit swelled fast, surpassing 6% of its GDP in 2006.

On the other hand, current account surpluses expanded in many emerging economies and oil-producing countries. Especially outstanding was the expansion of China's current account surplus with the advent of the 2000s. The current account deficit means a net increase in overseas liabilities. Prior to the financial crisis, capital flows from emerging economies and oil-producing countries to the United States assumed enormous proportions. It may be said that the global imbalance in capital flows led to the excessive boom of the US economy and the consequent occurrence of a financial bubble.

CHART 1

US current account deficit (% of GDP)



Source: Main Economic Indicators, OECD

2. Rebalancing of Capital Flows

The financial crisis has brought about a dramatic change in the above-mentioned global imbalance in capital flows. First, the excessively limited savings and extravagant consumption in the United States have undergone adjustment and the US current account deficit is shrinking rapidly. The US current account deficit, which exceeded 6% of GDP in 2006, fell short of 3% in 2009. A decline in the current account deficit also signifies a drop in the deficit in the trade balance – that is, exports minus imports. The US economy, which displayed a huge trade deficit as an export market for the rest of the world before the financial crisis, is now losing the status of a major world export destination following the outbreak of the financial crisis.

On the other hand, exports to emerging economies, which have been quick to recover from the financial crisis, are boosting their share of world trade. At a time when domestic demand of developed countries cannot be counted upon for global economic growth, exports bound for emerging economies have a tremendous role to play for the sustainable growth of the world economy. Emerging economies, buttressed by the brisk recovery of domestic demand, are now changing from the world's "factories" to "markets." As a consequence, the global flow of capital is increasingly marked by rebalancing – shifting from a flow "from emerging economies to the United States" to that "from developed countries to emerging economies."

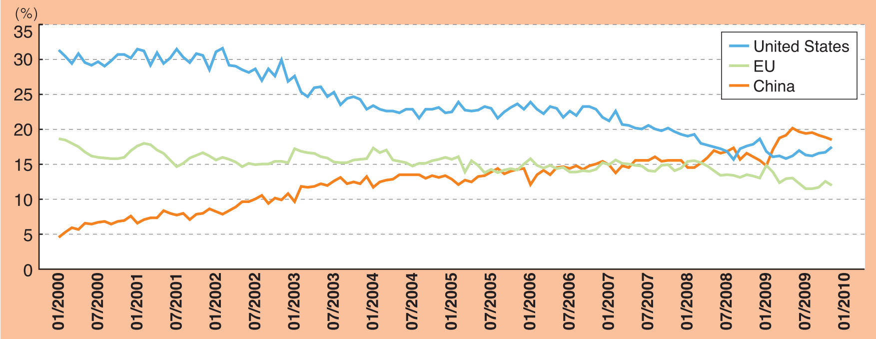
3. Growing Asia & Japan

At present, the world's trade structure is undergoing a shift from a "unipolar" concentration of exports on the United States to a "multipolar" pattern spearheaded by exports to emerging economies. In particular, great expectations are being placed on exports to smoothly growing Asia. Japan is showing a marked recovery in Asia-bound exports in contrast with the stagnation of exports to Europe and the United States after the financial and economic crisis. In 2009, China replaced the United States as the largest export destination for Japan *(Chart 2)*. As the middle and wealthy classes continue to increase in Asian countries, the region's domestic demand as "the market" has become an indispensable factor for the Japanese economy to achieve sustainable growth.

Intra-Asian trade has expanded substantially in parallel with the deepening of economic relations. Consequently, the proportion of intra-Asian trade surpassed 50% in recent years. In particular, the dependence of trade on China has increased remarkably over the past several years. Asia has already sur-

CHART 2

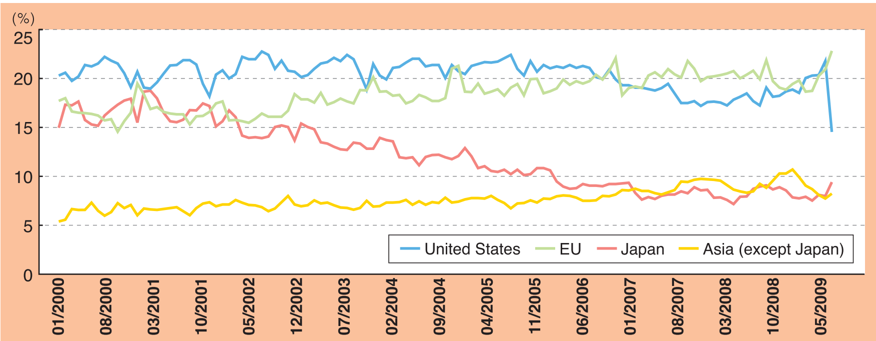
Japan's major export markets (% of total exports)



Source: Direction of International Trade, IMF

CHART 3

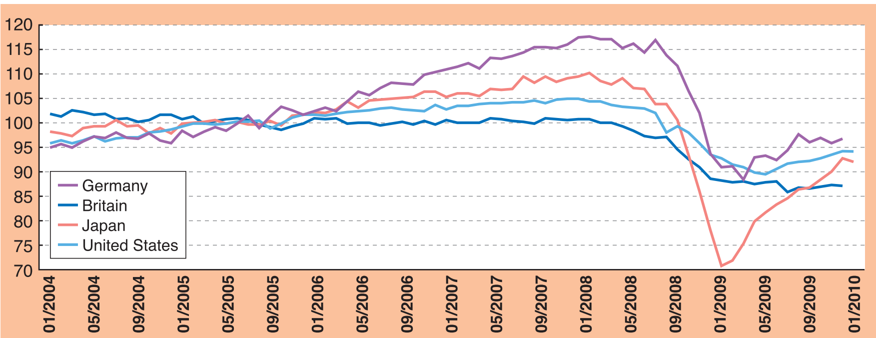
China's main export markets (% of total exports)



Source: Direction of International Trade, IMF

CHART 4

Production index trends in major countries (2005=100)



Source: Main Economic Indicators, OECD

passed Europe and the United States in terms of the overall value added of manufacturing industries. It may be said the Asian economy is now establishing its status as the factory of the world. Japan is not only intensifying the ratio of intra-Asian trade, but also developing its production networks in East Asia such as on-the-spot procurements by Japanese companies incorporated in Asian countries.

4. Asia Depends on US/Europe for Consumer Goods Exports

Nonetheless, although internal transactions within Asia are getting increasingly animated, the ratio of intra-Asian exports of consumer goods is still lagging at a low level, indicating no structural change in Asia's international trade that heavily depends on ultimate demand in Europe and the United States. In particular, China as an export center of final products has continued to show a high degree of reliance on exports to Europe and the United States even in recent years *(Chart 3)*.

In the early stage of the financial crisis, proponents of the so-called "decoupling" theory, citing the high intra-Asian trade ratio in Asia as a primary reason, came up with the prediction that the crisis originating from Europe and the United States would have only a slight impact on the Asian economy. However, as the crisis in the West worsened and exports to the region shrank, intra-Asian trade also slowed down rapidly. Japan was no exception, and a sudden fall in exports plunged the country into a serious recession, with its real quarterly GDP down 10% (in annualized terms) in the fourth quarter of 2008 and the first quarter of 2009 compared with the preceding quarters. This represented the biggest fall in production after World War II, except for a period of chaotic turmoil immediately after the war. Japan thus registered the steepest drop in the production index among major developed countries *(Chart 4)*.

The lesson learned from the latest crisis is that it is important for the Asian region to increase not only intra-regional trade in general, but also intra-regional trade of consumer goods to achieve a stable growth of the regional economy. Asian nations boast outstandingly high savings ratios compared with those of other regions. This has so far contributed to limiting the role of Asian domestic demand as an export destination for consumer goods. However, the high savings ratios also suggest that much room is left for the potential expansion of domestic demand at a rapid pace. At a time when the middle and wealthy classes continue to increase, further expansion of Asian consumption is called for so as to achieve self-propelled stable growth.

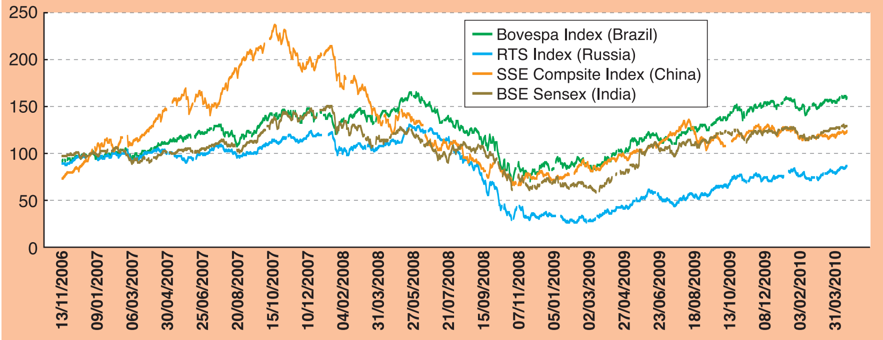
5. Problems of Growth Strategy

The Japanese economy has been stagnated by the slowdown of growth for a long time after the collapse of the asset-price bubble in the early 1990s. This was partly because a delay in "internal globalization" except in some manufacturing industries, including automobiles, caused Japan to lag behind in international competition. Meanwhile, because of intensified competition with the expanding markets of emerging economies, increased imports of low-priced goods have resulted in deepening domestic deflation. Nevertheless, Japan's geographical proximity to fast-growing Asian countries also offers a great chance to achieve sustainable growth.

In order to develop in parallel with the growth of Asia, Japan needs to provide consumer goods that can attract Asian consumers with a sense of safety and reassurance. By so doing, Japan can hope for

CHART 5

Stock price index trends in major emerging economies (end of 2006=100)



Source: Financial Quest, Nihon Keizai Shimbun

the overseas advance of not only manufacturing and other traditional export industries, but also domestic demand-type industries and service trades. Asian consumers are keenly interested in "made in/by Japan" goods. Japan leads the world in environmentally friendly and energy/resource-saving technologies. Japan has no small potential to take advantage of its technological superiority in winning business chances in the world's expanding environment-related industries. Japan is called upon to adapt its growth strategy to the post-crisis new world by capitalizing on its strength in the spheres of medical, health and nursing care services and cultural industries (such as content, fashion, agriculture/food, distribution/retail and tourism) to build new economic growth models and strategies. Asia is expected to further boost its need for consumer goods. In the near future, China is likely to replace Japan as Asia's biggest consumer market. The expansion of Asian domestic demand provides Japan with a great opportunity to achieve sustainable economic growth.

Asia/Pacific-wide cooperation is important for the further development and sustainable growth of Asia. In East Asia, a network of free trade agreements (FTAs) and economic partnership agreements (EPAs) has already been established, centering on the Association of Southeast Asian Nations (ASEAN). In order to achieve an even wider-ranging economic integration, it is necessary to step up various approaches for the improvement of the regional free trade system by such means as further stimulating various forms of economic cooperation such as Japan/China/South Korea cooperation, ASEAN+6 and FTAAP (Free Trade Area of the Asia-Pacific). Countries and regions affiliated with the Asia-Pacific Economic Cooperation (APEC) forum vary widely in economic structure, but they are bound together by complementary relations. Some APEC members primarily export machinery and other industrial manufactures, while other members rely mainly on exports of natural resources and other primary products. It is essential to expand intra-regional trade while making the most of such complementary relations.

6. Unstable Factors of Emerging Economies

Nonetheless, unstable factors exist in the rebalancing of post-crisis international capital flows. In particular, we need to note that the worldwide excessive liquidity, persisting since before the crisis, has contributed to the accelerated expansion of emerging economies' presence in the world economy. Now that international capital flows have been liberalized, massive amounts of funds circulate around the globe in an instant. Investors in various parts of the world, who vigorously invested in the United States before the financial crisis, are now redirecting the investment of their tremendous amounts of funds to emerging economies. In some emerging economies, anxiety is now spreading as regards the excessive skyrocketing of their domestic asset prices, such as stock prices *(Chart 5)*. Commodity and crude oil prices, which fell for a while, are starting to rise again. This upsurge is steep even considering that in the background is soaring demand mainly in developing countries.

Moreover, capital flows into emerging economies due to extreme monetary relaxation in various countries and the resultant currency "carry trade" are feared to enhance a tendency to the bubble economy. In the "carry trade," investment funds, raised at low interest rates, are changed into foreign currency that ensures high returns. Before the crisis, funds raised at low cost were mainly invested in US stocks and real estate. After the outbreak of the financial crisis, however, such funds have been redirected to emerging economies' markets and commodity markets, greatly boosting these countries' asset and commodity prices, which in turn has generated new surplus liquidity. The extreme credit relaxation is already affecting money flows to no small extent not only in the countries that have taken such a policy, but also in the world economy as a whole.

7. New International Monetary System Needs to Be Designed

If the skyrocketing of asset and commodity prices not only heightens upward pressure on prices but also causes an excessive price surge in the form of a new bubble, reaction will eventually become inevitable in the form of price collapse. Today, national borders no longer exist in capital flows. Therefore, if the adjustment of imbalance in capital flows takes the form of a hard landing, it will impact the entire world economy. All nations of the world are called upon to seek a soft landing-type solution through policy-making cooperation while paying due heed to what has caused the current global savings glut. In this process, the government and the central bank of each country need to make a policy decision while paying attention to a possible impact not only on their own country, but also on the world economy as a whole.

When viewed from the angle of designing a new system of international finance, numerous problems remain to be tackled in East Asia as to how best to proceed with the system design, although this region has achieved remarkable economic growth in recent years. In many Asian countries, a large part of their domestic savings first tends to flow out to Europe and the United States in spite of their high savings ratios. Funds thus channeled to the West have shown a tendency to revert to Asia in the form of highly speculative funds and thereby heighten risks in this region. The construction of a safety net through the designing of a new international finance system constitutes an urgent policy issue for the Asian region. JS

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