White Paper on International Trade 1999

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Chapter 1 The World Economy in 1998: High Roads and Low Roads

While the world economy had sustained high overall growth levels from 1994 onward, hit developing countries particularly hard. As a result, real GDP growth rates for 1998 present a picture of economic slowdown in Japan and many developing countries on the one hand, underpinned by booming U.S. and European economies on the other (Table 1).

In terms of the economic situation among developed countries, the dividing line fell between U.S. and Europe with their sustained economic expansion and a Japan plagued by sluggish domestic demand. Turning to developing countries, the growing severity of the economic crisis led to a marked economic slowdown in East Asia, which in turn affected other developing countries, causing major economic deceleration and low economic growth rates across the board.

Reflecting this slowdown in the world economy, the rate of increase for world trade volume in 1998 slipped heavily from the 9.7% of the previous year to a low 3.7% year-on-year.

World economic deceleration also impacted heavily on the price of crude petroleum and other primary goods. For those countries highly dependent on primary goods exports, this tumble in primary goods prices has impacted heavily in the loss of reduced foreign currency income. For countries importing primary goods, on the other hand, lower import prices served to reduce inflationary pressure.

In terms of capital, while the flow of capital from developed countries into East Asia and other emerging markets in the 1990s led to the smooth expansion of these markets, since the Asian currency crisis, the above impact on the real economy has been accompanied by increasing uneasiness as to emerging market prospects, with international money market turbulence prompted by sudden flows of capital affecting Russian and Central and South American exchange and money markets in particular.

As a result of these economic trends, the fall-off in exports to sluggish developing countries markets and reduced profits for companies moving into these markets have become factors slowing or threatening to slow the growth of the U.S. and European economies.

Table 1 Trends in World Real GDP Growth Rate

	Real GDP Growth Rate (%)								
	1990	1991	1992	1993	1994	1995	1996	1997	1998
World	2.7	1.8	2.5	2.6	4.0	3.7	4.3	4.2	2.2
Advanced Economies	2.8	1.2	1.9	1.2	3.2	2.6	3.2	3.2	2.0
United States	1.2	▲ 0.9	2.7	2.3	3.5	2.3	3.4	3.9	3.9
European Union	3.1	1.7	1.1	▲ 0.5	3.0	2.4	1.8	2.7	2.8
Japan	5.1	3.8	1.0	0.3	0.6	1.5	5.0	1.4	▲2.8
Developing Countries	4.0	5.0	6.6	6.5	6.8	6.0	6.5	5.7	2.8
Asia	5.6	6.6	9.5	9.3	9.6	9.0	8.2	6.6	2.6
Western Hemisphere	1.0	3.8	3.3	3.9	5.2	1.2	3.5	5.1	2.5
Middle East and Europe	5.6	3.5	6.5	3.9	0.7	3.8	4.7	4.5	3.3
Africa	2.3	1.8	0.3	0.7	2.1	3.0	5.8	3.2	3.6
Countries in Transition	▲ 3.5	▲ 7.6	▲14.0	▲ 7.3	▲ 7.1	▲ 1.5	▲ 1.0	1.9	▲0.8
Central/Eastern Europe		▲10.7	▲ 5.2	0.2	3.3	5.5	3.7	3.2	2.9
Russia		▲ 5.4	▲19.4	▲10.4	▲11.6	▲ 4.8	▲ 5.0	0.7	▲5.7
Transcaucasus/Central Asia		▲ 5.7	▲18.5	▲10.4	▲11.4	▲ 4.7	▲ 3.7	1.0	▲4.2

Notes: 1. Figures announced by the IMF in December 1998 (Figures for 1998 are predictions).
2. Figures for Central/Eastern Europe do not include Belarus and Ukraine.
3. The United States' 3.9% growth rate for 1998 was obtained from a March 1999 announcement by the US Department of Commerce.

Source: IMF, *World Economic Outlook.*

Chapter 2 The Changing Japanese Trade Structure and Recent Trade Trends

1. Trends in Trade in Goods and Services: Sluggish Domestic Demand Expands Surplus

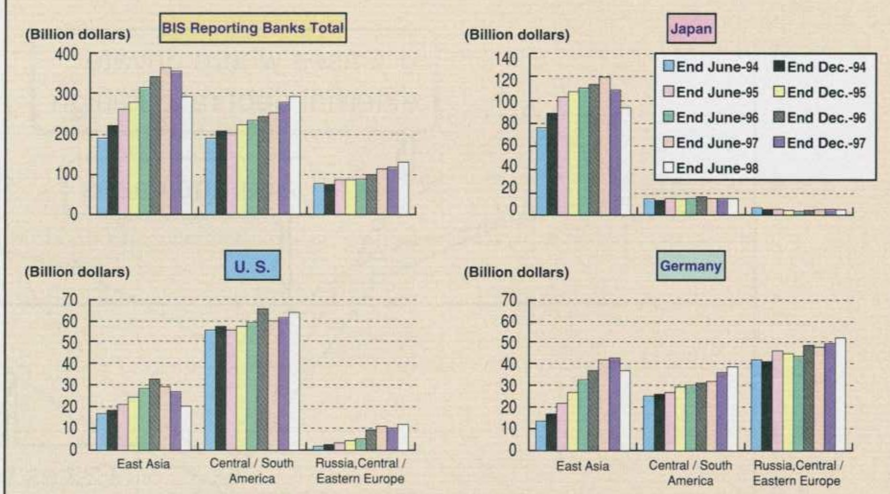
Japan's 1998 trade and services balance amounted to ¥9.6 trillion on a BOP basis, a 1.9% against nominal GDP. The trade surplus of ¥16.0 trillion — ¥48.9 trillion in exports (down 1.3% year-on-year) and ¥32.9 trillion in imports (down 11.7%) — was a new high, surpassing the ¥15.8 trillion of 1992. In terms of the service balance, while both credit and debit decreased compared with 1997, payments fell further, resulting in a ¥6.4 trillion deficit, down 2.1% from the previous year.

Looking more closely at the 1998 export and import trends, the polarization of the world economy as indicated in Chapter 1 produced only a slight overall decrease as reduced exports to East Asia were balanced out by an increase in exports to the economically buoyant U.S. and Europe. Imports, on the other hand, slipped heavily due to Japan's reduced import volume in the face of economic stagnation, as well as the plunge in import prices brought about by falling primary goods prices and the Asian currency crisis, resulting in the 1998 trade surplus expansion.

Recent Japan-U.S. Trade Trends

With the U.S. economy maintaining high economic growth while the Japanese economy experienced a marked slowdown, 1998 trends in trade with U.S. show no sign of the reduced trade surplus which should have resulted from the structural changes, with a sharp trade surplus expansion occurring instead. Trends in the trade balance with U.S. in dollars indicate that the trade surplus, having shrunk from 1995 onward, underwent a reversal in 1997 and ballooned out to US$51.4 billion in 1998.

Figure 1 Amounts Outstanding of Credit of BIS Reporting Banks Total, Japan, U.S. and Germany by Region



Note: Figures for East Asia are totals of seven countries, excluding Hong Kong and Singapore. EU figures are totals of 13 countries, excluding Portugal and Greece.
Source: BIS, *The BIS Consolidated International Banking Statistics.*

Japan-East Asia Trade Trends

Exports to East Asia in monetary terms dropped below zero in 1998. By region, this slowdown in exports has been most severe in the case of the ASEAN 4 and the Republic of Korea, the countries affected by the economic crisis. Almost all commodities have seen decreases since the Asian economic crisis, with a particularly heavy slump for the formerly expanding area of capital equipment.

Imports from all East Asian countries contributed negatively, with total imports decreasing by around 10%. By commodity, not only did imports of industrial supplies fall below zero, but capital equipment also undercut the zero mark, if only slightly, despite their earlier strong performance.

Imports from countries hit by the economic crisis did not increase as much as initially anticipated because (a) the importer, Japan, had slipped into an economic recession and (b) the tumble in local currency values was not entirely reflected in import price falls. In regard to (b) in particular, one major reason was that because the ASEAN 4 depend on importing many of the parts needed for production (as is evident in the high import ratio of parts and other capital equipment), the higher cost of parts, etc., resulting from the currency crash, pushed up product export prices.

2. Japan's Expanding Current Account Surplus and Capital Flow-Back Trends

The 1998 current account surplus rose 38.7% on the previous year to approximately ¥16 trillion, or 3.2% of nominal GDP. Compared to past years, while this is certainly a record level on a value base, eclipsing the 1986 figure of 14.2 trillion and the 1993 figure of 14.7 trillion, as a ratio of nominal GDP it falls below the 4.2% recorded in 1986 but exceeds the 1993 level of 3.1%.

Next, comparing Japan's current account surplus with that of the G7, Japan's 1997 trade surplus fell short of Italy, Germany and Canada. Moreover, a surplus of trade and services which corresponds to the external demand of the GDP under the System of National Accounts (SNA) undercut these three countries and also France. Even in comparison with the G7, Japanese figures are by no means outstandingly high.

Chapter 3 Globalization of Economic Activities and Deepening Multi-Layered Interdependence in the World Economy

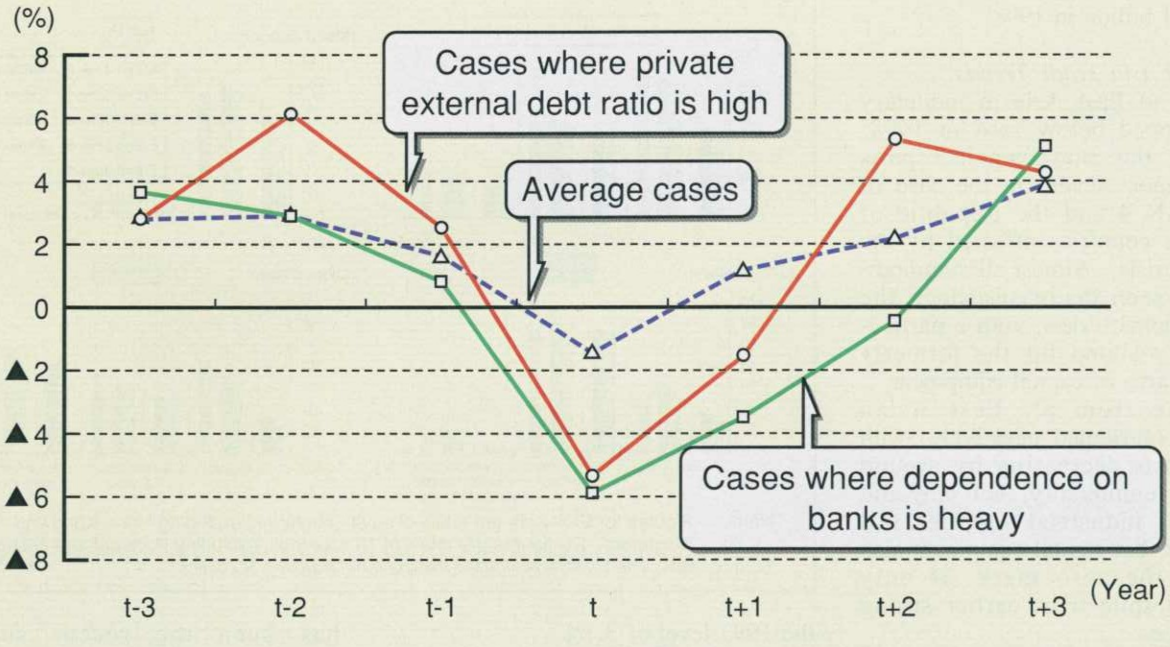
Greater direct investment is impacting heavily on Japan's changing trade structure. According to the United Nations Conference on Trade and Development (UNCTAD), world foreign direct investment has been on the rise, with a record level of more than US$420 billion expected for 1997.

A major factor behind this recent increase in direct investment and the accompanying trade structure changes has been the recent surge in international business activities.

In particular, the overseas expansion of most transnational corporations based in developed countries was once primarily into other developed countries, however, the recent worldwide trend toward trade and capital liberalization and the transition to the market economy in socialist countries have also boosted expansion into developing and emerging markets in East Asia, Central and South America, Russia and Central and Eastern Europe.

The surge in cross-border corporate activity and other elements of the globalization of economic activities has also energized worldwide capital flows. Amounts outstanding of credit extended by developed countries to emerging markets is on the increase in East Asia, Central and South America, Russia and Central and Eastern Europe. Amounts outstanding of credit ratios tend to be higher between neighboring regions (Figure 1).

Figure 2 Real GDP Growth Rate When Dependence on Banks is Heavy and When Private External Debt Ratio is High in Cases of Currency Crisis With Financial Crisis



Note: "t" denotes the year the currency crisis occurs.
Source: IMF, *International Financial Statistics*; World Bank, *World Development Indicators and Global Development Finance.*

Chapter 4 Expansion of the Asian Currency Crisis and Real Economy Deterioration

1. The Asian Currency and Economic Crisis: Factors and Characteristics

To clarify which of the various elements generally described as fundamentals were related to the emergence of the currency crisis, a Frankel and Rose model* was used to produce a probit analysis of approximately 100 major currency crises which have occurred to date. We examined which factors were observed around the time of the currency crisis in East Asia. The result was that 1990s-type factors—short-term debt ratios, foreign currency reserves and disparities between domestic and foreign interest levels—were apparent in all countries. The Asian currency crisis therefore bears an overall resemblance to the average currency crisis of the 1990s.

From among currency crises accompanied by financial crises, those involving a high private external debt ratio (at least 10% of GDP)* and heavy bank dependence (M2 at least 40% of GDP)** produced the following results (Figures 2, 3). Where currency crises are accompanied by financial crises and involve a high private external debt ratio or heavy bank dependence, factors such as the severance of capital supply to the industrial sector and the slump in not only domestic demand but also the export increase, combine to induce a steep economic nose-dive on the outbreak of a currency crisis, generally requiring some years to recover.

• Frankel and Rose model* : An equation based on the work of Jeffrey A. Frankel and Andrew K. Rose (1996), with slight changes made in regard to the countries covered, the period of estimation and explanatory variables.

• high private external debt ratio (at least 10 percent of GDP)*: The ratio (private external debt / GDP) for Thailand, Indonesia and Malaysia was over 10%.

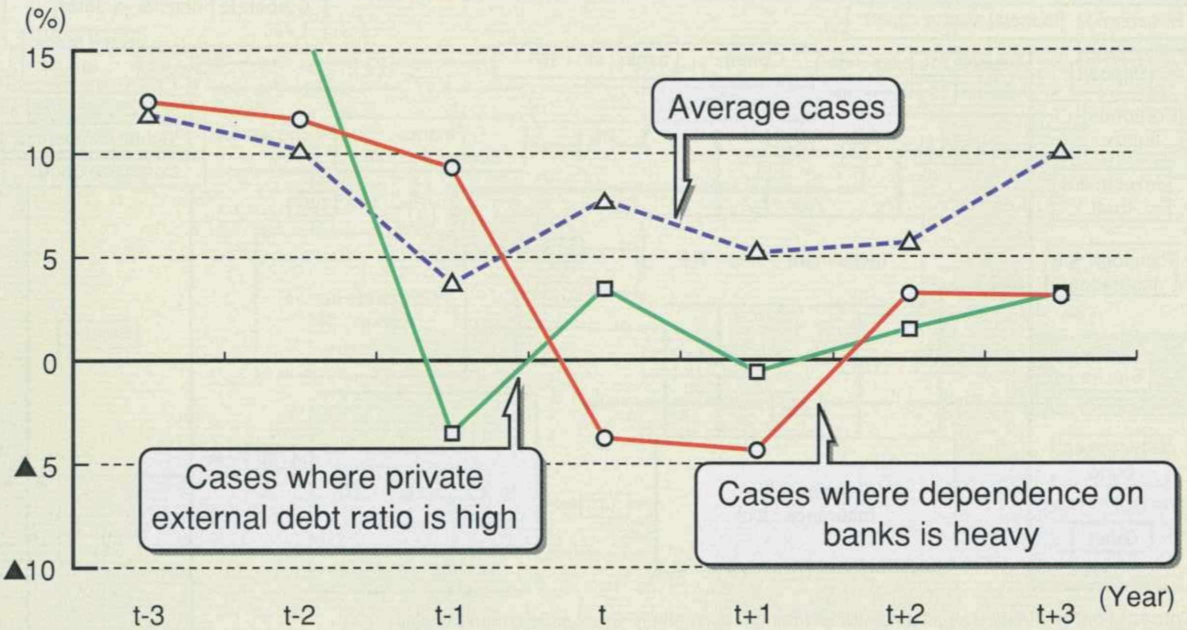
• heavy bank dependence (M2 at least 4% of GDP)** : The ratio (M2 / GDP) for the ASEAN 4 and the Republic of Korea was over 40%.

2. Malaysian Regulatory Measures and the "Trilemma Theory"

While Malaysia had adopted IMF-style tight fiscal and monetary policies, the government announced a package of measures for the introduction of foreign exchange and capital transaction regulations and a shift to fixed exchange rate system in September 1998.

From the "trilemma theory" of the international financial system (refers to the basic limitation in international financial system design, whereby it is

Figure 3 Export Growth Rate When Dependence on Banks is Heavy and When Private External Debt Ratio is High in Cases of Currency Crisis With Financial Crisis



Note: " t " denotes the year the currency crisis occurs.
Source: IMF, *International Financial Statistics*; World Bank, *World Development Indicators and Global Development Finance.*

impossible to simultaneously achieve exchange rate stability, free capital flows and monetary independence), the basic thinking behind IMF-style prescriptions is that monetary independence has to be sacrificed to maintain free capital flows and exchange rate stability; however, this approach produced massive side-effects in the form of an accelerated economic downturn and increasingly severe non-performing loan problems. The regulatory measures introduced by Malaysia, on the other hand, can be said to have sacrificed free capital flows in favor of monetary independence (economic stimulation through low interest rates) and exchange rate stability (fixed exchange rate system).

Chapter 5 Toward Stable Development of the Asian Economy

In Asian countries affected by the recent crisis, in order to ensure an early economic recovery and set their economies back on a medium to long-term growth path, they will have to overcome the various factors which expanded a currency crisis into a serious economic crisis and work to increase medium to long-term potential growth capacity.

First, consideration of new international financial system reforms should be promoted in order to open the way for stable real economy development in developing countries, which lack the resilience and flexibility of developed countries.

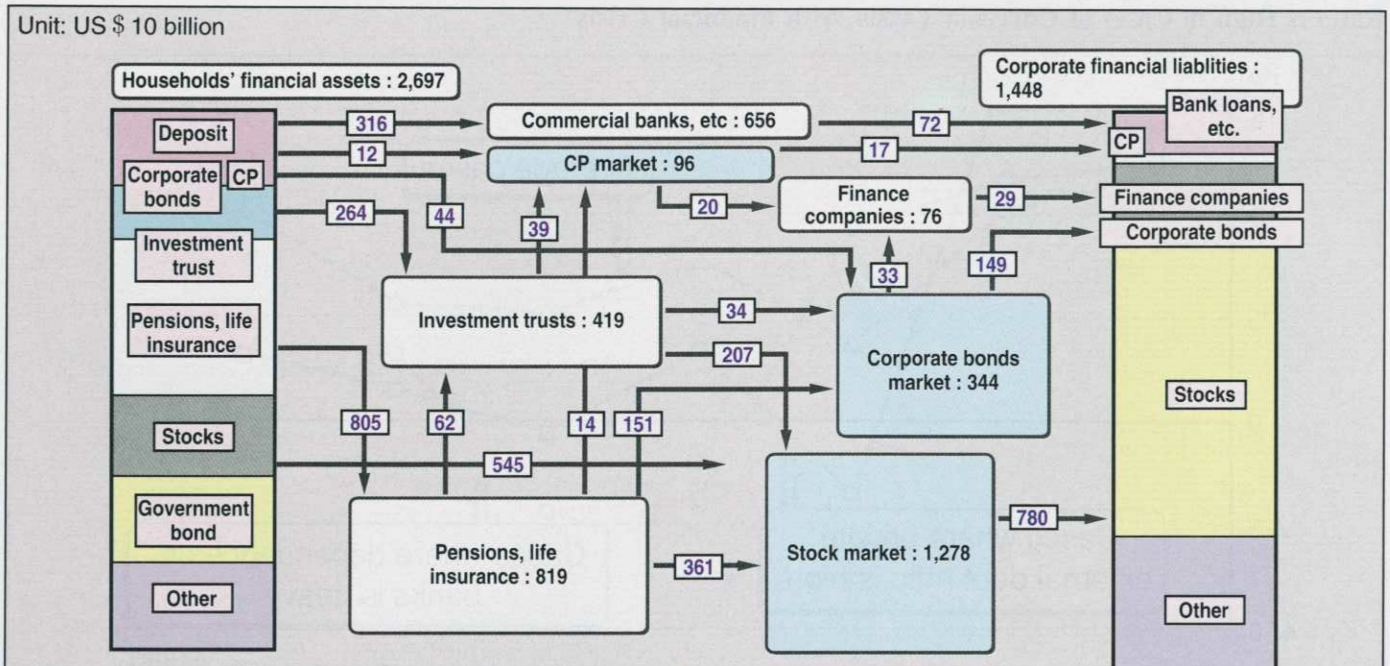
Second, it will be important to reform financial systems to improve the ability of financial institutions to appropriately assess risk in the case of profitable companies; and to promote the collation and disclosure of information on the finances of borrowers.

Another urgent task will be to promote economic structural reform through human resources development, infrastructure development and the fostering of small and medium-sized enterprises and supporting industries. In particular, to develop supporting industries by fostering local companies is obviously a pressing task in terms of rebuilding the economy through export expansion.

The crisis-hit countries are also experiencing a reduction in the direct investment which has to date been the engine for growth. Underdeveloped legal systems, policies lacking transparency and prone to sudden change and other elements reducing the predictability of the business environment would seem to be standing in the way of investment, there need efforts toward greater predictability.

Moreover, reflecting back on the recent crisis, there have been growing calls among the Asian countries for a break away from excessive dollar dependence, increasing the need to push forward the internationalization

Figure 4 1997 Main Financial Intermediation in the U.S.



Note: Figures show the finance asset balances of finance mediation institutions and market scale. Evaluation is on current prices.
Source: FRB, *Flow of Funds Accounts of the United States.*

of the yen. In developing the yen internationalization it will be important to increase the stability of the value of the yen, the convenience of raising and investing yen funds, and convenience of conversion (with Asian local currencies, etc.) of the yen.

Trade and investment between the Asian and Japanese economies has created a close and multi-layered interdependence; therefore to stage an early export-led recovery and achieve coherent economic development in Asian economies, the Japanese economy must break out of the current recession as soon as possible, re-establishing itself as a world front-runner. This will mean urgently addressing the revitalization of the economy by developing the various key environmental aspects in industrial revitalization, including measures to stimulate short-term demand, encourage new business, facilitate corporate buy-ups, mergers and reorganization, and facilitate labor mobility.

Chapter 6 Japanese Industrial Finance Amid Globalization: Current State and Challenges Faced

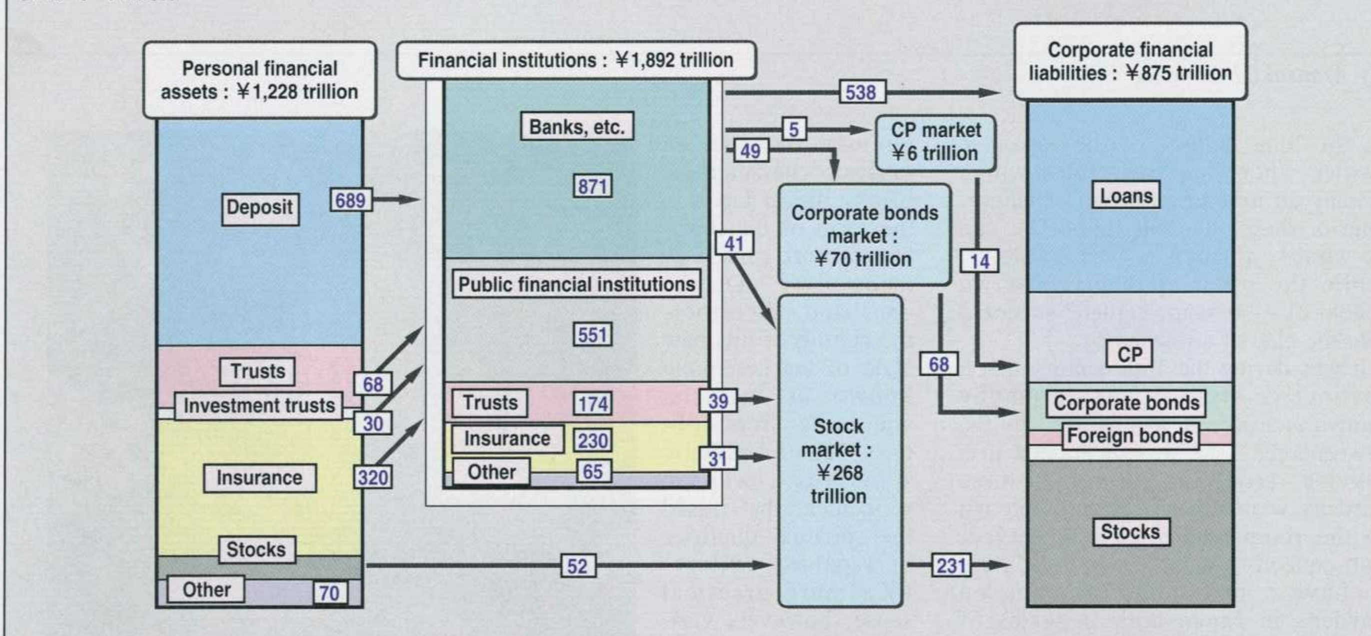
The world economy of recent years has seen financial systems in general begin to impact heavily on the real economy, partly because all corporate activities are embedded in these, and also because financial systems have been marked the most extensively by globalization.

Problems in Japanese industrial finance can be condensed into the following three points. First, indirect financing plays an overly dominant role in the route taken by capital from the hands of households, capital suppliers, to the recipient companies, while more diverse capital intermediation channels through capital markets have not been sufficiently developed (Figure 4, 5) Second, the lack of depth in capital supply in terms of the various capital intermediation routes obstructs the smooth supply of capital to companies with credit ratings below a certain level, such as middle-ranked and small and medium-sized companies and new business areas, all of which have limited physical mortgage capacity. Third, an extremely serious problem unique to the Japanese economy is the way in which the excessive corporate capital demand and consequent relaxed bank lending of the bubble period, as well as the growth of equity finance, have left financial institutions staggering under a mountain of non-performing loans and borrowing companies carrying excessive debt, weakening both parties.

The following efforts will be vital in resolving these issues. First, to diversify capital intermediation routes, it will be important to expand direct financing by ensuring information disclosure increasing the liquidity of commercial paper, and enforcing market players. Second, to enhance financial intermediation functions, the credit risk management capacity of

Figure 5 Main Financial Intermediation Structure in Japan (September, 1998)

Unit: ¥ Trillion



Note: Figures for financial institutions are the balances of financial assets.
Source: BOJ, *Economic Statistics Monthly*

financial intermediation institutions should be improved and a variety of interest rates set in line with risk levels. Third, the financial structures of both banks and companies need to be improved and corporate governance strengthened.

Chapter 7 New Trends and Challenges for the International Trading System

The development of the multilateral trading system has in recent years been characterized by (a) the wider range of players (e.g. developing countries) involved in free trade negotiations and (b) instances where an important role has been played by regional cohesion and integration, such as the front-running liberalization efforts by APEC and NAFTA.

Taking the case of 'trade in services' and 'investment', the Uruguay Round produced agreement on multilateral rules (GATS and the TRIMs Agreement), but factors such as consideration given to the position of developing countries at the rule formation stage have left inadequacies in terms of rule content and coverage which will need to be addressed in the years ahead. Multilateral rules also need to be developed for areas such as intellectual property, competition policy, anti-dumping, electronic commerce and international harmonization, and here the World Trade Organization should be utilized as a forum where the simultaneous participation of many countries allows efficient rule formulation.

The regional integration has revealed the following positive aspects. First, there has been a trade and investment expansion effect. Besides, according to regional integration theory, the higher ratio of intra-regional trade is likely to reduce the negative effect (effect of trade conversion) and increase the positive effects (effect of market expansion and promotion of competition). Second, the international economic rules will lean further toward the harmonization of domestic systems, which will increase the merits of prior development of neighboring regions with similar economic and social circumstances. Third, in the course of post-war rounds of trade negotiations, groups engaged in regional cohesion and integration have come to play an increasingly positive role in the system enhancement.

Japan should obviously redouble its efforts toward the success of the next WTO negotiations. In addition, to supplement the multilateral trading system, Japan should seek to deepen intra-regional exchange and understanding in Northeast Asia, applying itself with greater vigor to the development of regional cohesion and presenting a model which will contribute positively to the strengthening of the multilateral trading system. JJTI