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Financial Instability and International Imbalances: the View from Japan

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Progress in rebalancing?

1. In the latest World Economic Outlook (WEO) published in early October, the IMF notes that achieving sustained healthy growth over the medium term depends critically on rebalancing the pattern of global demand. It calls on many current account surplus economies that have followed export-led growth strategies to rely more on domestic demand growth to offset likely subdued domestic demand in deficit economies that have undergone asset price busts. It also argues that many external deficit countries would need to rely less on domestic demand and more on external demand. How should the recent performance of the Japanese economy be assessed in this context?

2. Japan's economic expansion between 2002 and 2007, the longest in the post-war history, was indeed propelled by sharp advances in exports which accounted for about two-thirds of real GDP growth. Export growth was supported by the yen's fall and growing demand in other Asian countries, in particular China which was a major source of external demand, boosting Asia's share of Japanese exports to almost half. Export advances, in turn, led to buoyant business investment growth, accounting for a third of the rise in Japan's output. Total output increased at an annual rate of 2.1 per cent during the expansion, while private consumption remained weak and underlying inflation negative.

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3. Japan's expansion stumbled by late 2007, and in the context of the global economic crisis, it has been trapped into the deepest recession of the post-war era.

4. Initially, the impact of the global crisis on the Japanese economy was expected to be limited because Japanese banks and other financial institutions were relatively insulated from financial turmoil. However, between the third quarter of 2008 and the first quarter of this year, Japan's exports fell at an annual rate of some 55 per cent in volume terms, the sharpest among OECD countries and double the area's average rate of decline. While exports have rebounded since then, the IMF projects a decline in Japan's net exports (gross exports minus gross imports) for this year as a whole, making a significant negative contribution to domestic output which is forecast to amount to 2.4 per cent of real GDP. As a result of this and a sharp drop in domestic demand, real GDP this year is projected to decline by 5.4 per cent.

5. On the other hand, for the US, the epicenter of the global financial crisis, the IMF projects its net exports to make a positive 1.2 percentage points contribution to real GDP growth this year, the same amount as for last year. Thus, despite a sharp contraction of domestic demand, the decline in US GDP is forecast to be limited to 2.7 per cent, just a half of output decline projected for Japan this year. For the UK, another epicenter of the financial crisis, the IMF projects net exports to make a positive 0.8 percentage point contribution to real GDP growth this year, after a positive 0.4 percentage point contribution last year, thus limiting a contraction of UK real GDP to 4.4 percent. While the IMF expects a negative output contribution of net exports for the euro area this year, it is forecast to amount to 0.8 per cent of GDP, just one third of the equivalent number for Japan.

6. As a result of such rebalancing, the contribution of net exports to real GDP growth in Japan for the ten-year period of 2000-09 as a whole is most likely to average just 0.1 percentage point at an annual rate while real GDP growth is forecast to average 0.6 per cent at an annual rate, according to the OECD Economic Outlook 85 database. Japan will thus most likely enter into the second decade of this century as an OECD country which has at least not worsened global imbalances.

7. In passing, let us note that the contribution of Japan's net exports to real GDP growth was 0.3 percentage point at an average annual rate in the 1980s and 0.1 percentage point in the 1990s.

Note also that the equivalent numbers for the ten-year period of 2000-09 are for Germany 0.4 percentage point, 1.3 percentage points for China and just 1 percentage point for Korea. It is also important to note that even with no changes in net export volumes, Japan's huge foreign investment income helps to maintain its current account position in surplus, unless oil and other primary commodity price hikes and other terms of trade changes inflate Japan's external payments in dollar terms.

8. Looking ahead, the IMF in its latest WEO notes that the turnaround in the global manufacturing cycle is expected to raise current account surpluses for Germany and to a lesser extent for Japan. Indeed, it projects Germany's surplus as a ratio to its GDP to rise to 3.6 per cent in 2010 from 2.9 per cent in 2009 (to be compared with 7.5 per cent in 2007 and 6.4 per cent in 2008). Japan's surplus as a ratio to its GDP, which amounted to 4.8 per cent in 2007 and 3.2 per cent in 2008, is projected to decline to 1.9 per cent this year and then rise very slightly to 2.0 per cent in 2010. The positive contribution of net export volumes to real GDP is projected to amount to 1.2 per cent of GDP for Germany in 2010 after a negative 3.6 percentage contribution in 2009, and for Japan, 0.7 per cent in 2010 after a negative 2.4 per cent in 2009. In this context, it is important to note that most recent further rise of the Japanese yen, not reflected in the WEO, by itself should work to reduce Japan's net export surplus projected for next year.

The yen appreciation and deflationary pressure

9. Over the medium to long term, as the drag on economic growth from population ageing increases, sustaining an improvement in living standards in Japan will depend crucially on accelerating labour productivity growth through structural reform. But, in the shorter term, the most important issue is how to run demand management policy to achieve faster aggregate demand growth to narrow the existing wide output gap and stem deflationary pressure [1]. On the fiscal front, with government debt having reached the highest level ever recorded in the OECD area, Japan is becoming increasingly vulnerable to a rise in the long-term interest rate from its current low level of around 1 1⁄2 per cent. The task of supporting demand therefore falls heavily on the shoulders of the Bank of Japan.

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[1] The consumer price index in October 2009 was 2.5 per cent (1.1 per cent excluding food and energy prices) below a year earlier level.

10. A major challenge to demand management in Japan at the present time is to find ways to counter the deflationary pressure arising from further rises of the yen exchange rate not only against the US dollar but also against the currencies of China and other emerging Asian and Latin American economies which manage their exchange rates against the US dollar.

11. We must of course note that the decline in Japan's export volumes at an annual rate of some 55 per cent in volume terms between the third quarter of 2008 and the first quarter of this year occurred against the background of global export market contraction. However, according to the OECD estimate, the decline in the size of Japan's export market for this year is 16.6 per cent, not much different from the OECD area average of 15.4 per cent. The second factor contributing to a dramatic decline in Japan's exports is their composition which is heavily concentrated on automobiles and information and other sophisticated capital goods. Inventories of such products were squeezed more rapidly than those of other goods in Japan's export markets hit by the global financial crisis. The third factor is the yen's sharp rises since mid-2007. Its nominal effective exchange rate appreciated particularly sharply in the last quarter of 2008 and the first quarter of this year when the yen's rise against the US dollar was associated with declines of currencies of the UK, Canada, Australia, Korea and emerging economies in Asia[2] and Latin America against the US dollar. More recently, the yen advanced further and by late November its appreciation from the mid-2007 level amounted to 30 per cent against the US dollar, 24 per cent against euro, 29 per cent against the Chinese yuan, and 81 per cent against the Korean won (some 40 per cent in nominal effective terms[3] by mid-November).

12. These currency movements will exert unwelcome deflationary pressure on the Japanese economy basically through four channels. First, weaker exports demand will widen the output gap. Second, a further decline in import prices will accelerate consumer price deflation. Third, international cost comparison against Japan will encourage a further shift of production bases

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[2] 47 per cent of Japan's exports went to non-Japan East Asia (16 per cent to China and 8 per cent to Korea), while its exports to the US amounted to17 per cent and those to EU 14 per cent of the total in FY 2008.

[3] The real effective exchange rate (nominal effective rate adjusted for inflation differentials among countries) is a better indicator of international price competitiveness. The yen on this basis rose by 32 per cent between mid- 2007 and October 2009.

abroad by Japanese producers, aggravating business fixed investment and reducing employment at home. Fourth, those firms maintaining production bases at home will be forced to cut wages and other costs even more to cope with a further loss of international price competitiveness associated with the yen's sharper rise. Lower consumer prices will moderate the decline in real wages relative to nominal wages. Nevertheless, real wage cuts together with reduced employment will lower household income and consumption in real terms in a situation where Japan's personal saving rate has already been reduced to about 3 per cent, somewhat lower than current US and UK levels and far below Germany's rate.

Monetary policy with a zero interest rate bound

13. With a zero bound on nominal interest rates, intensified deflation will further increase real interest rates and weaken credit demand even more, thus entailing a deflation spiral. How can the Bank of Japan intend to deal with this difficult situation?

14. At a time when the Japanese economy suffered from the combination of the burst of its self-made bubble and the concomitant upward pressure on the yen in the 1990s, Professor Allan Melzer of Carnegie-Mellon University and some other American economists proposed the Bank of Japan to expand the monetary base and to put downward pressure on the yen. Indeed, Japan's base money expanded sharply but the yen's sustained weakening did not materialize. A reason for this given by Professor Melzer was an intervention by a then senor official of the US Treasury to stop the yen's adjustment.

15. In the context of dealing with the current financial crisis, the Bank of England has adopted a policy of expanding the monetary base to increase nominal demand and to ensure inflation on target. At the same time, the Bank reduced its policy rate very aggressively, so that it is not clear whether and how much the Bank's policy of "quantitative easing" has helped to drive down the UK pound.

16. Another interesting experiment has been tried by Canada. In its monetary policy report published last July, the Bank of Canada stated "a stronger and more volatile Canadian dollar could act as a significant drag on growth and put additional downward pressure on inflation for Canada", giving an indication about the level of the Canadian dollar beyond which the Bank

does not like to see it rise. This statement was made at a time when the Canadian dollar was fairly stable around a rate of one CN $ = 0.80 US $, some 20 per cent lower than a level prevailing a year earlier. The statement was preceded by the Bank of Canada's decision announced last April to make a conditional commitment to hold the central bank policy rate at 0.25 per cent until the second quarter of 2010. In the monetary policy report published in that month, the Bank outlined a framework describing unconventional measures it could employ, if needed, and principles that would govern the use of those tools. However, the Canadian dollar has since then rebounded to around par against the US dollar, suggesting that the statement has not produced the Bank of Canada's desired effect on the Canadian dollar.

17. A third interesting experiment is found in Sweden. In July this year, its central bank lowered the interest rate on its one-week deposit facility to negative 0.25 per cent at the same time when it squeezed its benchmark lending rate down to 0.25 percent. The actual amount left in that account appears to be far smaller than the overnight deposit facility on which it pays a 0.15 per cent interest rate. Nevertheless, the Swedish central bank has embraced a policy that could be used to deal with deflationary pressure.

Need for more effective multilateral surveillance

18. So far my policy discussion has centered on the role of monetary policy tools in fighting deflation in Japan. However, it is not complete unless policies followed by Japan's key partner countries most active in international trade and financial activities are considered squarely. The need to look at this aspect become clearer if readers return to the earlier part of this paper where deflationary pressures on the Japanese economy emanating from abroad are reviewed (see in particular para. 12).

19. Back in 2005, an unusually strong language of warning about the US external situation was used in the BIS Annual Report published in June. It argued that "the widening current account deficit of the United States is a serious long-term problem. That is, it could eventually lead to a disorderly decline of the dollar, associated turmoil in other financial markets, and even recession." It then stated that "the dollar had declined in an orderly manner, but mostly against currencies that are truly free-floating" (note that Japan has not been intervening in the foreign exchange market since mid-March 2004), and "given how little the US trade deficit seems to

have been affected to date by dollar depreciation, ・・・, some further movement seems almost inevitable", adding that "obvious candidates for revaluation would be the Chinese renminbi and other Asian currencies."

20. US trade partner countries as a whole must accept a smooth decline in the US dollar's effective exchange rate as a natural part of the desired process of reducing the US trade deficit and correcting global imbalances to the extent that effective efforts are made in the US to raise its national saving rate through budget deficit reductions over the years ahead together with a rise in private saving. However, the recent decline in the dollar's effective rate has occurred mainly through its sharp depreciation against yen and euro, as China and some other emerging countries have resisted appreciation of their currencies against the US dollar. Under normal circumstances, undesirably strong upward movements in a country's currency can be offset unilaterally by a reduction in its central bank policy rate. But, a zero interest rate bound has deprived the Bank of Japan of such possibility. While the Bank of Japan should consider some unconventional measures with uncertain effects on the exchange rate as discussed above, Japan's difficulty in domestic demand management could be dealt with more effectively, if multilateral surveillance on the international compatibility of key countries' exchange rate policies as well as fiscal and monetary policies were conducted more effectively than at present.

21. That said, effective multilateral surveillance[4] should be implemented not only in these policy areas, but it needs to be extended to structural reform issues in partner countries whose saving and investment patterns can have significant external influences, as I shall discus in a moment. According to the IMF, national savings as a share of GDP in China rose from 36.8 per cent in 2000 to 58.9 per cent in 2008 and those in India from 23.8 per cent to 37.0 per cent over the same period, as consumption tended to lag behind GDP growth. The corresponding figures for Japan and Germany during the 1980s when they ran persistently large current account surpluses were slightly above 30 per cent and around 23 per cent respectively. More recently, Japan's national saving rate declined from 28.0 per cent in 2000 to 26.6 per cent in 2008, while the German rate rose from 20.1 per cent to 25.6 per cent over the same period. Let us also note that the comparable figure for emerging market economies as a whole (that is to say, Asian and

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[4] See Kumiharu Shigehara, "Multilateral Surveillance: What the OECD can offer?"(OECD, Paris, 1996)

Latin American economies) rose from 29.5 per cent to 36.6 per cent over this period, while the US national saving rate declined from 18.1 per cent to 12.6 per cent.

22. Faster growth of domestic investment absorbing domestic savings in emerging market economies[5] should help moderate pressure toward export drive in the short run. But, if it results in excess output capacity over time, deflationary pressure could be generated and its undesirable consequence could spill over to the rest of the world. In the age of globalization, multilateral surveillance to facilitate better resource allocation in rapidly growing large emerging countries such as China and India should be conducted more or less in the same way as the OECD has been conducting for its member countries and some non-members. In some contrast to non-members in Eastern Europe, emerging Asian countries have been rather cautious about such international exercise. The non-member countries which have benefited from the OECD's structural surveillance could usefully persuade key Asian emerging countries that it would be first of all these countries themselves who would receive rewards from such exercise, although, given global linkages, its benefits would spill over to OECD countries and to the rest of the world more generally.

23. The issue of multilateral surveillance has become crucial in the light of developments in financial markets and international trade, information and communications technology, as well as transportation, that are bringing the world's economies and societies ever closer. As is clear from a review above of recent developments in the Japanese economy on which the adverse impact of the global crisis was initially expected to be limited because of the relative insulation of Japanese banks and other financial institutions from financial turmoil abroad, international policy spillovers across advanced countries and emerging market economies have become extremely important. Many of the economic and social challenges facing policy makers have been converging, and the range of policy issues that could potentially benefit from multilateral surveillance appears to be broadening. In this context of fundamental change, there is a heightened need for a careful examination of the roles of newly created international bodies such as G20 and those of the international institutions that were created to promote international

[5] The share of emerging market economies in global final demand at PPP exchange rates rose from 29.5 per cent in 2000 to 36.6 per cent in 2008 while the US share declined from 29.2 per cent to 27.0 per cent, the euro area's from 21.9 per cent to 19.1 per cent, and Japan's from 9.0 per cent to 7.7 per cent over the same period.

policy co-operation in the immediate post-war period, so as to meet the challenges of the new globalised world more effectively.

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