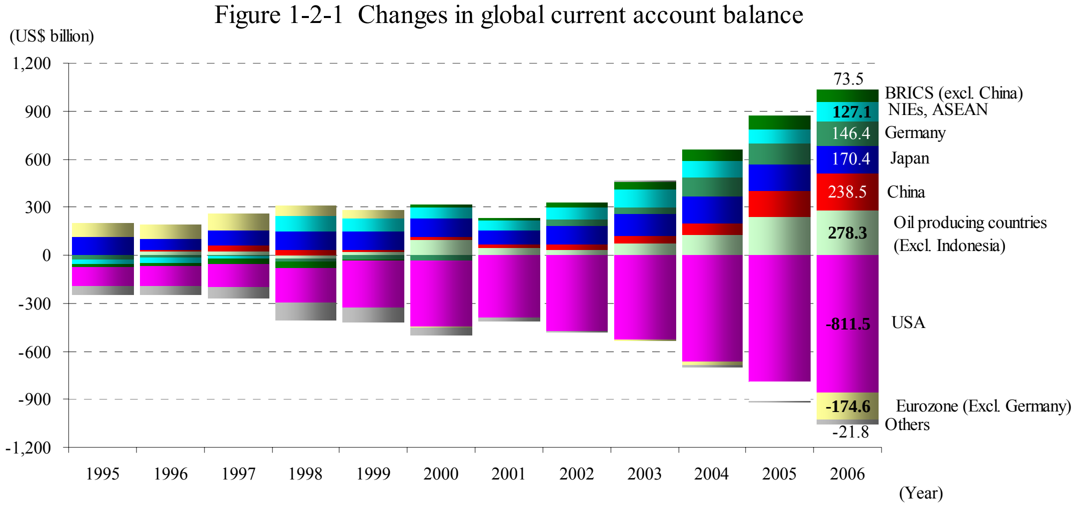
Section 2 Expansion of the global current account imbalance

1. Trend in the global current account in 2006

In 2006, the expansion of the global current account imbalance has continued. The United States, which accounts for a considerable part of the current account deficit in the world, had a record-high current account deficit in 2006 of US$811.5 billion (6.1% of nominal GDP), up US$56.6 billion from the previous year (Figure 1-2-1). The deficit of the goods and services trade, which accounts for approximately 90% of the current account deficit overall, was a record-high US$758.5 billion (5.7% of nominal GDP) in 2006. Furthermore, the balance on income, which has continued to be a surplus, has seen a decrease in the margin of surplus for two consecutive years since 2005.

Meanwhile, China continued to have strong exports, and oil-producing countries[7] benefited from the continued rise of crude oil prices annually on average. Both countries saw continued expansion of their current account surplus in 2006. China saw a current account surplus of US$184.2 billion, by approximately US$23.3 billion from the previous year, and oil-producing countries saw a current account surplus of US$355 billion, by US$115.8 billion. Meanwhile, there did not appear to be a significant change in the levels of the current account surpluses of Japan, ASEAN4, and NIEs.

Figure 1-2-1 Changes in global current account balance



Notes: Figures for 2006 are projected.
Source: World Economic Outlook Database, April 2007, (IMF); Website of the Bureau of Economic Analysis, Department of Commerce, USA.

A large current account imbalance creates pressure for adjustment of currency exchange levels. China, which has a rapidly expanding current account surplus but is slow to adjust currency exchange levels, continued the large-scale selling of yuan and buying of US dollars in order to reduce strong pressure for a higher yuan in 2006. As a result, China's foreign exchange reserves amounted to US$1.663 trillion in the end of 2006.[8] The foreign exchange reserves of oil-producing countries

[7] The oil-producing countries mentioned here are the participating countries of the Organization of the Petroleum Exporting Countries (OPEC) (as of 2006) excluding Iraq, i.e. the 10 countries of Iran, Kuwait, Saudi Arabia, Venezuela, Qatar, Indonesia, Libya, the United Arab Emirates, Algeria, and Nigeria.

[8] Based on a official announcement by the People's Bank of China.

(excluding Iran and Indonesia) also continued to increase, and they amounted to US$203.9 billion in the end of 2005 (Table 1-2-2). Meanwhile, the foreign exchange reserves of Japan, which have not carried out foreign exchange intervention since March 17, 2004 and the foreign currency reserves of ASEAN4 and NIEs did not appear to change significantly. The foreign currency reserve of Japan in the end of 2006 amounted to US$875 billion, and the foreign currency reserves of China, ASEAN4, and NIEs amounted to US$2.48 trillion.

Table 1-2-2 Changes in foreign exchange reserves of respective countries and regions

(unit: US$ billion at each year's end)

	2000	2001	2002	2003	2004	2005	2006
Japan	347	388	451	653	824	829	875
US	43	41	39	39	39	38	41
Euro zone	219	208	216	188	181	167	184
UK	34	29	31	29	34	36	39
China, NIEs, ASEAN4	657	725	877	1,110	1,446	1,690	2,048
China	166	212	286	403	610	819	1,066
NIEs	390	411	476	574	675	703	774
ASEAN4	102	102	115	133	162	168	207
BRICS (excluding China)	94	114	148	220	299	360	551
Oil producing countries	85	90	93	116	154	204	･･

Notes: oil producing countries excludes Iran as well as Indonesia.

Source: *IFS* (IMF), Central Bank of the Republic of China (Taiwan).

2. Current account of the United States continues to worsen

(8) Trade balance reaches record deficit

The US economy in 2006 continued the high level of growth that it saw in 2005, and the rate of real GDP growth amounted to 3.3%. This was due to factors such as the fact that while housing investment dropped significantly compared to the previous year, private capital investment centering on investment in information-related equipment and investment in structures continued to be strong and personal consumption was steady. Imports increased significantly and amounted to a record US$2.2042 trillion in 2006. Exports also continued to increase, amounting to US$1.4457 trillion, but due to the greater increase in imports, the deficit of the goods and services trade in 2006 reached a record US$758.5 billion (Table 1-2-3).

Table 1-2-3 Changes in current account balance of the US

(Unit: US$ million)

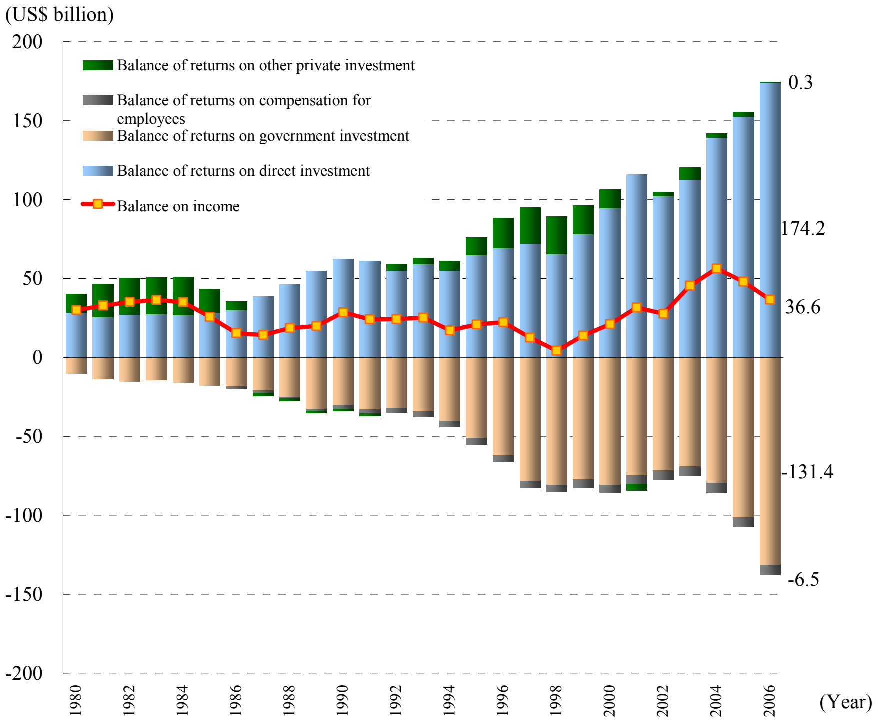
	1999	2000	2001	2002	2003	2004	2005	2006
Exports of goods and services	965,884	1,070,597	1,004,896	974,721	1,017,757	1,157,250	1,283,070	1,445,703
Imports of goods and services	-1,230,974	-1,450,432	-1,370,022	-1,398,446	-1,514,672	-1,769,341	-1,997,441	-2,204,225
Balance on goods and services	-265,090	-379,835	-365,126	-423,725	-496,915	-612,092	-714,371	-758,522
Balance on current account	-301,630	-417,426	-384,699	-459,641	-522,101	-640,148	-754,848	-811,477

Source: Website of the Bureau of Economic Analysis, Department of Commerce, USA.

(9) Decrease in the margin of the balance on income surplus

The margin of the balance on income surplus of the United States has decreased for two consecutive years since 2005 (Figure 1-2-4). This is mainly due to the fact that the deficit of the government investment income balance expanded.

Figure 1-2-4 Changes in income balance of the US



Source: Website of the Bureau of Economic Analysis, Department of Commerce, USA.

Assets held by the United States overseas rose to US$11.792 trillion in the end of 2005, but looking at the composition of these assets (Table 1-2-5), while risk is relatively high, direct investment (US$3.5 trillion) and stock investment (US$3.1 trillion), which appear to have high rates of return, account for 60% of the total. Investment in bonds, which has a relatively low rate of return, amounted to approximately US$1 trillion, accounting for a share of only 9%. Meanwhile, the foreign debt of the United States, in other words the total amount of assets held by foreign countries in the United States, amounted to US$13.6 trillion in the end of 2005, in which direct investment (US$2.8 trillion) and stock investment (US$2.1 trillion) accounted for a share of only 36% of the total. Investment in bonds by foreign countries (including US government bonds) amounted to US$4.6 trillion, accounting for 34% of the total.

Table 1-2-5 Position of US investment abroad (end of 2005)

(unit: US$ million)

Assets		Debts		Assets-Debts
U.S. Government assets	265,566	Government liabilities	2,722,423	(- 2,456,857)
U.S. official reserve assets	188,043			
US Government assets, other than official reserve assets	77,523	US Government securities	2,354,272	(- 2,644,900)
U.S. credits and other long-term assets	76,960	US Treasury securities	1,993,756	
US foreign currency holdings and U.S. short-term assets	563	Other	360,516	
		Other government liabilities	16,000	
		US Currency	352,151	
Private assets	10,813,636	Private liabilities	10,902,954	(- 89,318)
Direct investment abroad	3,524,459	Direct investment abroad	2,797,165	(727,294)
Outward securities investment	4,073,997	Outward securities investment (other than Treasury securities)	4,390,682	(- 316,685)
Bonds	987,543	Corporate and other bonds	2,275,197	(- 1,287,654)
Stocks	3,086,454	Corporate stocks	2,115,485	(970,969)
Loans	3,215,180	Debts	3,459,043	(- 243,863)
U.S. claims on unaffiliated foreigners reported by U.S. nonbanking concerns	784,521	U.S. liabilities to unaffiliated foreigners reported by U.S. nonbanking concerns	563,749	
U.S. claims reported by U.S. banks, not included elsewhere	2,430,659	U.S. liabilities reported by U.S. banks, not included elsewhere	2,600,632	
		U.S. liabilities reported by U.S. banks, not included elsewhere	294,662	
		Other foreign official assets	256,064	
Total	11,079,202	Total	13,625,377	(- 2,546,175)

Source: Website of US Department of Commerce.

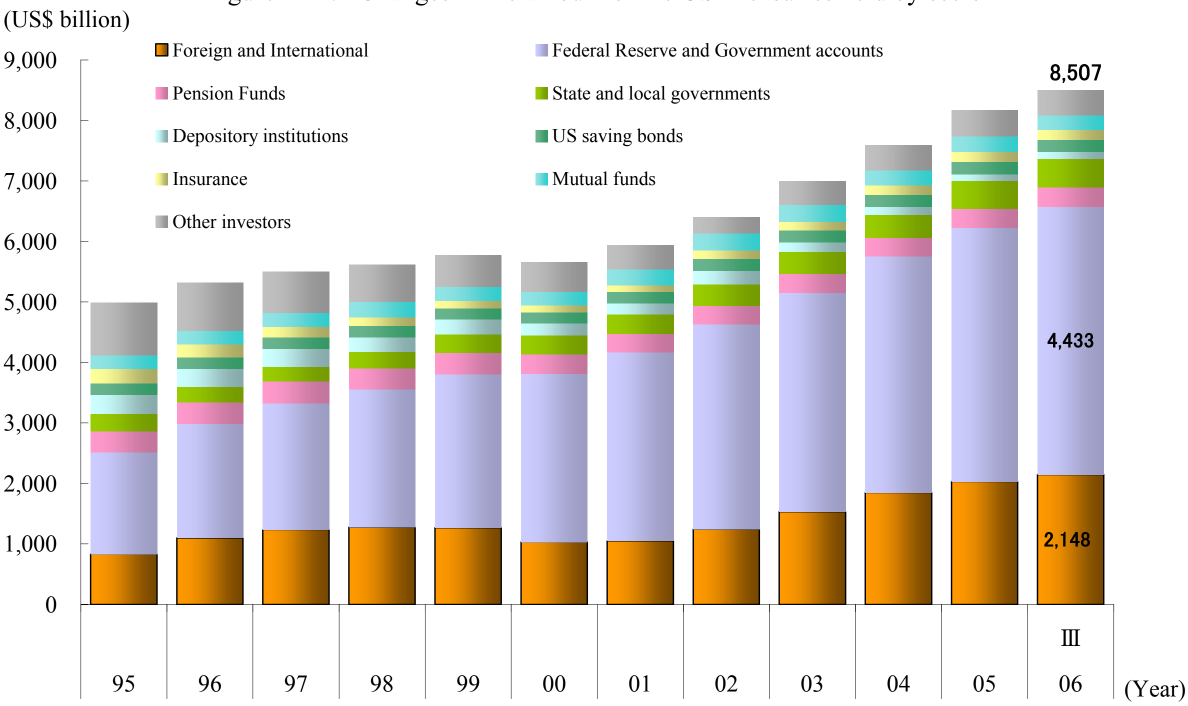
:Investment with low return

:Investment with high return

As already stated, the United States has carried out fund procurement from overseas centering on bonds with relatively low procurement costs, and has carried out asset management overseas centering on direct investment and stock invest with high rates of return. As a result, the United States has realized a surplus for balance on income up to now, although it is a net debtor nation, in which in terms of stock the amount of fund procurement from overseas is greater than the amount of asset management overseas.

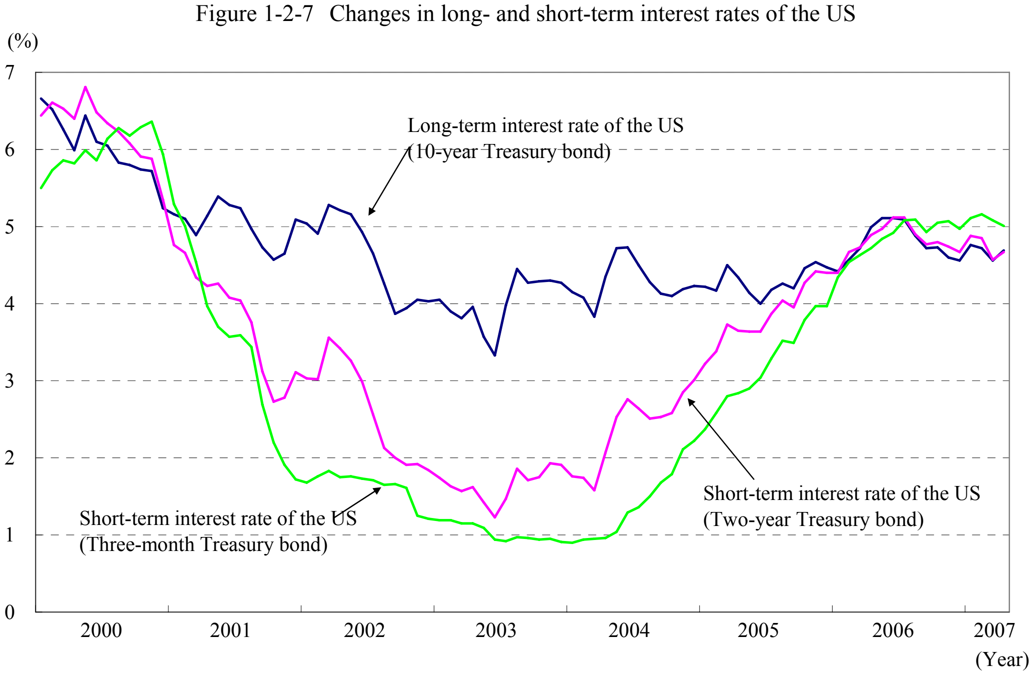
Despite this, however, the margin of surplus of income balance from 2005 onward declined for two consecutive years. The reason is that, the margin of surplus for direct investment income balance increased gradually from 2003 onward, the deficit in balance of returns on government investment continued to expand significantly on the other hand. It seems that factors behind the expansion of the deficit margin of balance of returns on government investment include an increase in the amount of interest payments due to the 2 facts: that investment in US Treasury bonds and US government agency bonds from overseas has been expanding year to year, and that from 2004 onward, short-term interest rates—and from 2005 onward, not only short-term interest rates, but also long-term interest rates—saw an underlying upward trend (Figure 1-2-6 and Figure 1-2-7).

Figure 1-2-6 Changes in the amount of the US Treasuries held by sector



Notes: Amounts are the value at the end of each year. 2006 is the value at the end of the third quarter.
Source: *Treasury Security Bulletin* (US Department of the Treasury).

Figure 1-2-7 Changes in long- and short-term interest rates of the US



Source: Website of US Board of Governors of the Federal Reserve System (FRB).

There appears to be a possibility that the income balance of the United States will turn into a deficit , and the United States will enter a new phase in which it is an advanced debtor country that relies on the inflow of capital in the future (Table 1-2-8). The United States, as a country which rapidly industrialized in a similar manner to the United Kingdom, has started to reach the most advanced stage up to this time, based on the theory of stages of development in balance of payments[9]. The United States had became the world's largest capital supplier after World War II, and it achieved economic development as a "mature creditor nation" from the 1970s through the 1980s. Its current account has got into the red from 1983 onward,, but the United States has maintained a positive returns on investment balance through the inflow of capital into the United States and active foreign investment. Nevertheless, in 1989, the United States had a net debt to foreign countries, and furthermore, from 2005 onward, the margin of its surplus for its balance on income has continued to decrease mainly due to the expansion of interest payments and redemption expenses for US Treasury bonds accompanying rising interest rates and worsening of the financial deficit.

Table 1-2-8 International balance of payments development stage theory and US balance of payments

	Situation of US balance of payments	Current account	Balance on goods and services	Balance on income (balance on investment income)	Net external assets	Capital and financial account
I. Immature debtor nation		-	-	-	-	+
II. Mature debtor nation	1871~1890	-	+	-	-	+
III. Debt repayment nation	1891~1910	+	++	-	-	-
IV. Immature creditor nation	1911~1940 1946~1970	++	+	+	+	- -
V. Mature creditor nation	1971~1983	+	-	++	++	-
VI. Credit disposition nation	1983~1989	-	-	+	+	+
VII. Investment income balance maintained by advanced debtor nations	1989~2006	-	-	+ deficit?	-	+
VIII. advanced debtor countries fully relying on capital inflow	?	-	-	-	-	+

Notes: International balance of payments development stage theory is originally indicated on six stages, but considering the recent US situation, two stages are added.
Quoted by: Uchimura (1998) compiled by METI.

(10) Expanding net external debt

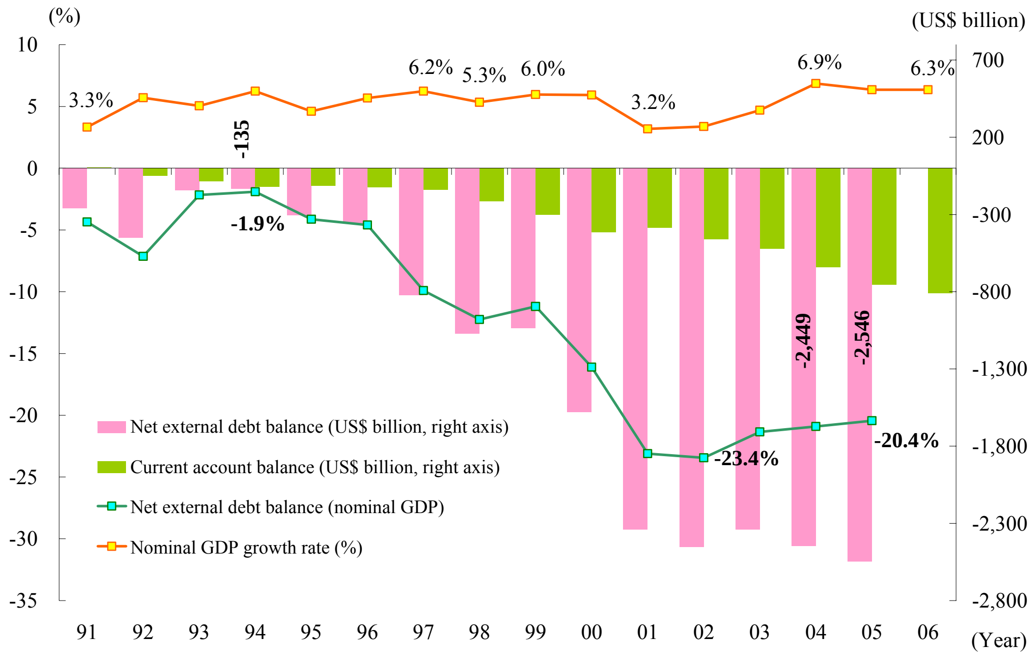
Faced by a worsening current account deficit, the United States saw a continuous expansion of its net external debt, which hit a record high of US$2.5462 trillion at the end of 2005. The country saw a declining trend, however, in its net external debt in nominal GDP terms from the end of 2003 through the end of 2005 (Figure 1-2-9). This declining trend can be attributed to: (a) a consistently weakening trend in the US dollar since 2002, which has reduced the assessed value of US external debts, the majority of which are denominated in the US dollar, while boosting the assessed value of US external assets, the majority of which are denominated in foreign currencies;[10] (b) an appreciation in the assessed value of external assets such as corporate stock held by the United States, and; (c) a surplus in US income balance (Figure 1-2-10).

9 Based on Crowther, G (1957). "International balance of payments development stage theory is a theory explaining changes to the structure of the balance of payments based on a long-term perspective, combining the process of the accumulation of assets, focusing on the fact that the IS balance of a country changes in accordance with economic development. As a method of classifying the structure of the balance of payments of countries, Crowther divided the stages of development of balance of payments into six stages using mainly the two criteria of whether a country was a creditor nation (balance on income is positive) or debtor nation (balance on income is negative) and whether a country was a capital importer (balance of capital account is positive) or a capital exporter (balance of capital account is negative).

10 Roubini and Setser (2004), "The US as a Net Debtor: The Sustainability of the US External Imbalances."

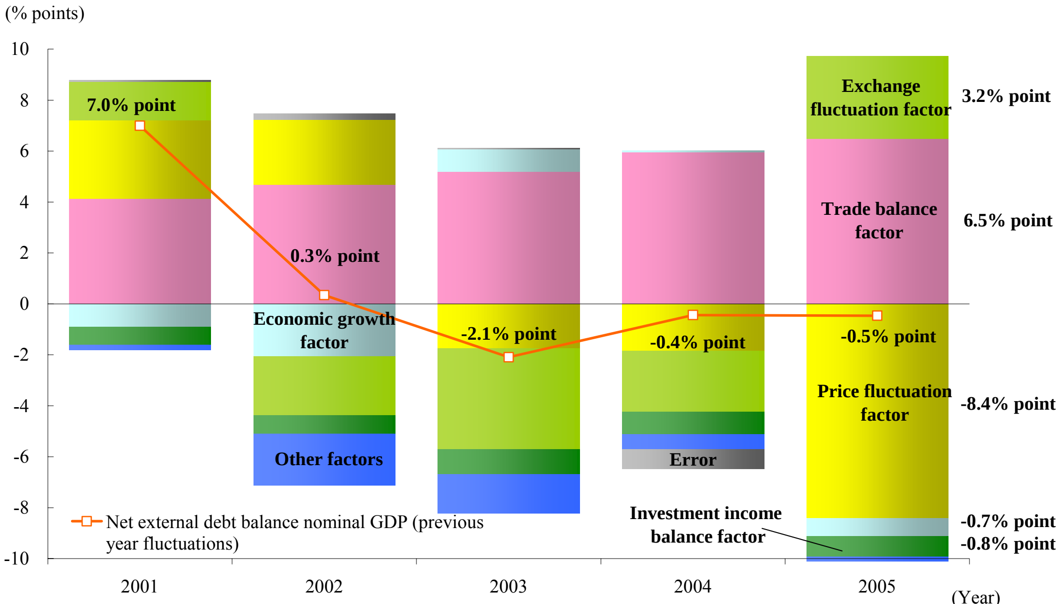
Nevertheless, there is concern that the net debt to foreign countries as a percentage of GDP will increase in the future, in light of (a) the flattening out of the nominal effective exchange rate of the US dollar from 2005 onward, (b) the continued worsening of the trade balance, (c) the unlikelihood of external asset prices of the United States, including stock prices, continuing to rise in the long term, and (d) the decrease in the margin of surplus for the balance on income for two consecutive years from 2005 onward. It is thus necessary for the United States to try to control this by reducing its trade deficit to a certain degree (Figure 1-2-11).

Figure 1-2-9 Changes in net external debt balance of the US



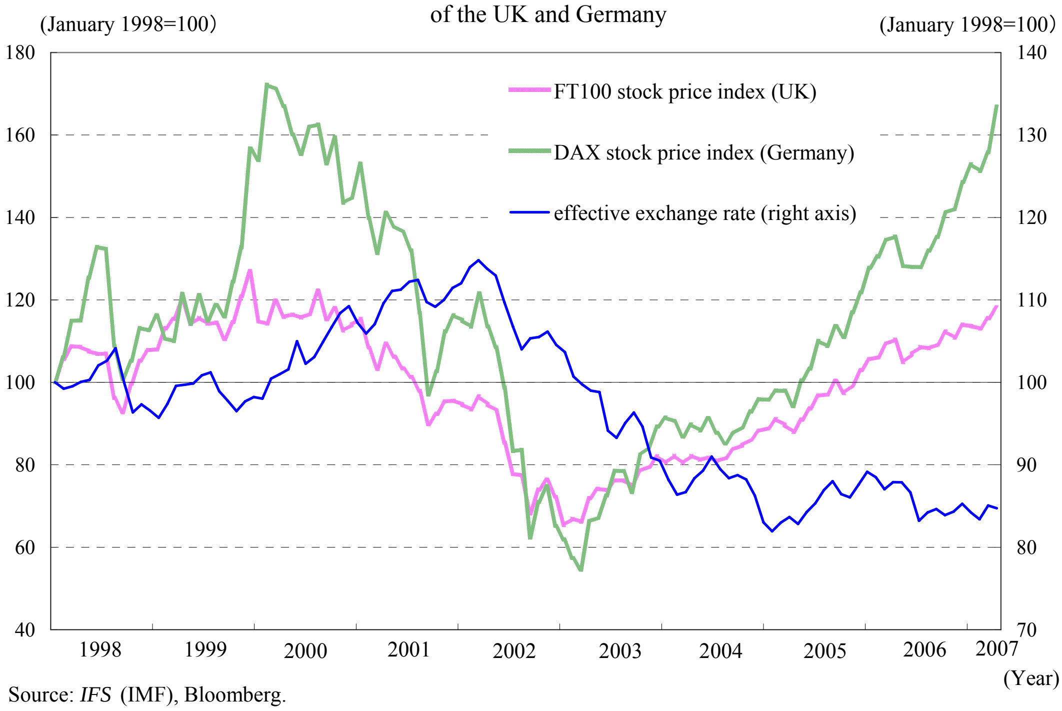
Source: Website of the Bureau of Economic Analysis, Department of Commerce, USA.

Figure 1-2-10 Fluctuation factor breakdown of net external debt balance compared to nominal GDP (year-on-year fluctuations)



Notes: See appended note 1-1 for calculation method.
Source: Website of the Bureau of Economic Analysis, Department of Commerce, US.

Figure 1-2-11 Changes in effective exchange rate fluctuations and stock price indexes of the UK and Germany



Source: *IFS* (IMF), Bloomberg.

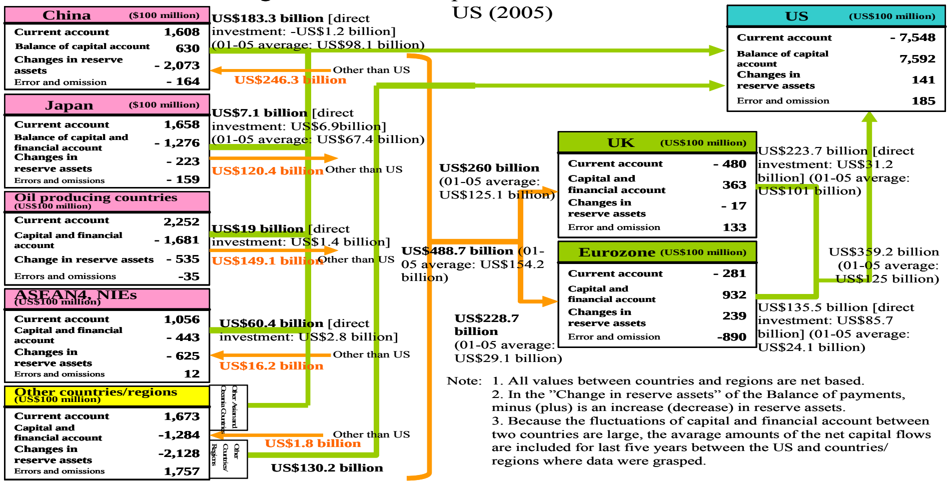
3. Mechanism for the inflow of funds into the United States

At present, with the expectation that the current account deficit of the United States will continue, it is essential that the inflow of funds from overseas into the United States takes place smoothly. Looking at the international net fund flow into the United States in terms of international balance of payments, it can be seen that the United Kingdom and Eurozone, which like the United

States are countries and regions with a current account deficit, are an important intermediary base for the flow of funds of the world to the United States, through the pumping of funds as a result of having a significantly greater fund flow than they need themselves (Figure 1-2-12).

One factor behind the United Kingdom and Eurozone playing a financial intermediary function is the fact, that oil-producing countries have accounts for the settlement of oil export proceeds and so forth in banks in the United Kingdom and Europe. Some of the oil-producing countries historically have deep ties with European countries such as the United Kingdom, and it is said that these countries often commission banks in European countries where they have opened accounts for the settlement of international transactions, for the operation of large sums of money.

Figure 1-2-12 Net capital flows from the world to the US (2005)



Notes: 1. Balance of payments (within the box) of oil producing countries is 10 OPEC nations including Iraq, excluding Indonesia (2005). The 01-04 average capital flow from the Eurozone to the US is that from European region to US.
2. Among oil producing countries, the capital and financial account of United Arab Emirates (UAE) is composed of the 2 constituents (private corporations, public corporations). In private corporations sector, direct investments are considered as direct investments of UAE, both securities investments and securities investments of the bank sector are considered as securities investments of UAE, and other investments of the bank sector are considered as other investments of UAE. Therefore neither private non-bank sections nor public corporation sections were included. In the capital and financial account of Qatar, "changes in reserve assets" and "errors and omissions" were omitted. The data of Iran is that of 2004, and the capital and financial account was omitted. The data of Iraq is that of 2004.

Source: *BOP* (IMF), *IFS* (IMF), *International Transaction Accounts*, *Survey of Current Business April 2006* (US Department of Commerce), *Central Bank of Taiwan statistics* (Central Bank of China (Taiwan)), *ANNUAL REPORT 2005* (United Arab Emirates Central Bank), *ECONOMIC REPORT 2005* (Qatar Central Bank), *STATISTIQUES DE LA BALANCE DES AIMENTS L'ALGERIE* (Central Bank of Algeria), *Qatar Central Bank Database* (Qatar Central Bank), *Annual Bulletin 2005* (Central Bank of Iraq).

4. Towards reducing the current account imbalance

A factor behind the global current account imbalance is the global imbalance of the IS balance, in other words, the bipolar structure of the United States, which lacks savings, and China, ASEAN4, NIEs, and oil-producing countries, which lack investment. The problem of the global current account imbalance is not a problem that can be resolved between the United States and certain countries and regions; it is a problem that needs to be addressed by the United States and various countries as a common international issue.

Major reasons that the inflow of funds into the United States has continued and expanded ever include: (a) the position of the US dollar as a key currency and its high marketability, (b) the maintenance of the financial market in the United States, (c) the control of the increase of the net debt to foreign countries of the United States as a result of the rate return of external assets topping the rate of return of external debts and the continued surplus of the return on investment balance, and (d) investors developing a fondness for the United States as a safe destination for investment following the Asian currency and financial crisis in 1997, the Russian currency and financial crisis in 1998, and the Brazilian currency and financial crisis in 1999.

There is no knowing if this type of situation will continue in the future. In order to stop the expansion of the current account imbalance, it is necessary for the United States to decrease its current account deficit going forward, as well as the global current account imbalance needs to be adjusted by surplus countries, such as China, ASEAN4, and NIEs, with efforts aimed at decreasing their current account surplus.

(1) Issues on the United States side
(Need for improvement of savings-investment balance)

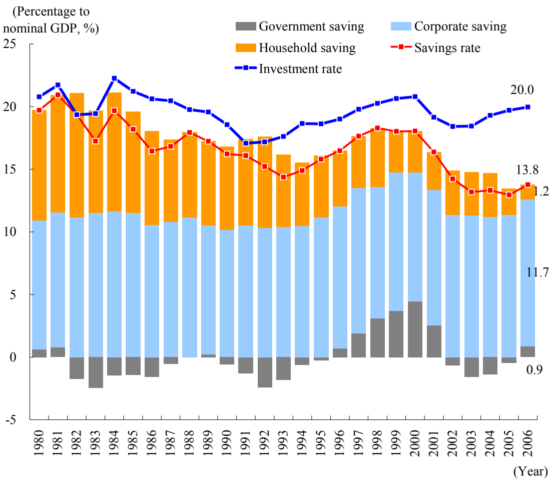
The worsening of the trade imbalance and current account deficit of the United States is also a manifestation of the imbalance of the savings-investment balance in the government and household sectors in the United States. Recent trends in this regard are covered below.

Looking at it in terms of trends, the current account of the United States was a deficit from the 1980s onward, not because the rate of investment as a percentage of GDP increased, but rather due to deficit savings in the US economy resulting from a decrease in the rate of saving. The decrease in the rate of saving was caused by a downward trend in saving not in the corporate sector, but in the household sector (Figure 1-2-13).

Looking at changes in the IS balance by sector, while the government sector was the center of investment excess from the 1980s through around the mid-1990s, the corporate sector was the center of the investment excess from the latter half of the 1990s through 2000, when the IT bubble burst. From 2001 onward, while the corporate sector shifted to saving excess,[11] the government sector posted a budget deficit and became the center of investment excess again. Furthermore, from 2003 onward, the margin of investment excess of the household sector expanded, and as a result, in spite of the margin of investment excess of the government sector starting to decrease from 2004 onward, the current account deficit has been expanding rapidly (Figure 1-2-14). The shortage of funds arising from this is being offset mainly by the overseas sector.

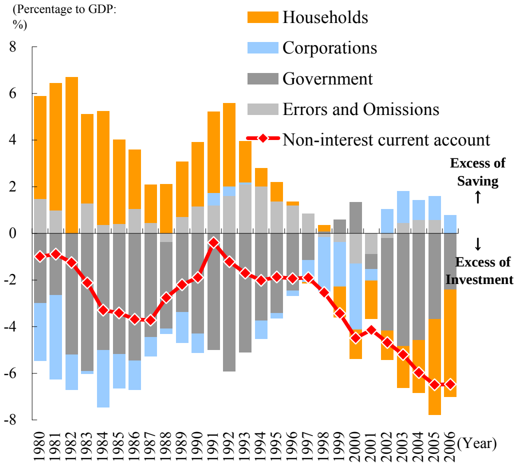
[11] In the United States, the cash flow of companies is at an extremely high level due to factors such as (a) the completion of balance sheet adjustments by companies following the burst of the IT bubble, (b) the realization of efficient management practices through significant cost reductions, and (c) the strong economy in recent years. Meanwhile, companies are cautious about equipment investment following the bursting of the IT bubble, and many companies have come to carry out equipment investment within the scope of an ample cash flow. It appears that as a result, there is excess savings in the corporate sector.

Figure 1-2-13 Saving trend by sector in the US



Source: Website of the Bureau of Economic Analysis, Department of Commerce, USA.

Figure 1-2-14 Changes in IS balance by sector in US

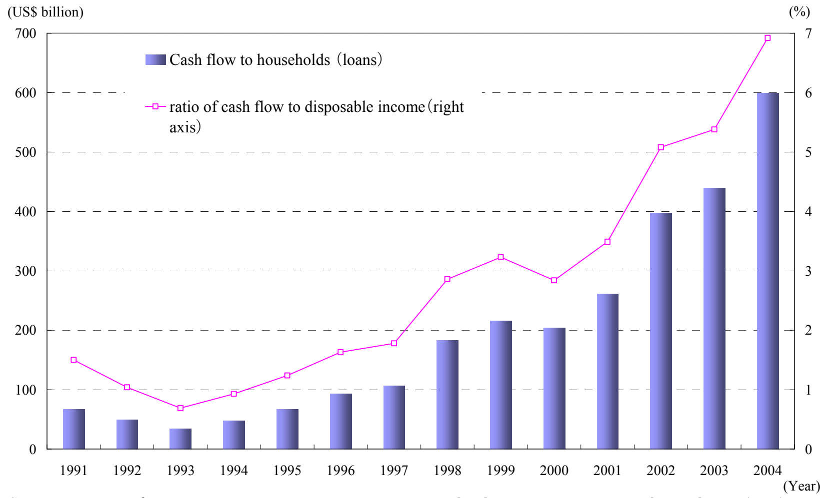


Notes: Non-interest current account = Trade balance + Unilateral current transfers + Compemsation of employee

Source: Website of the Bureau of Economic Analysis, Department of Commerce, USA

Within this, the household sector increased borrowing through the cash-out refinancing (conversion of loan) of housing loans (carrying out an increase conversion using the amount of increase in the assessed value of home equity, and liquidating part of this), home equity loans, and so forth, against the backdrop of the increase in housing prices and the low rate of interest, and steady consumption has continued coupled with an increase in disposable income due to lower taxes (Figure 1-2-15).

Figure 1-2-15 Changes in cash flow to households through the home equity loans



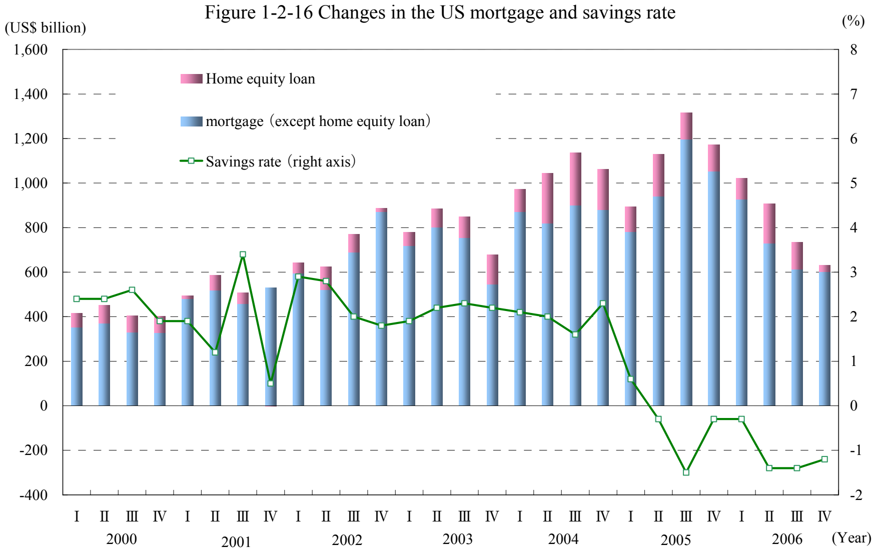
Source: *Estimates of Home Mortgage Originations, Repayments, and Debt On One- to Four-Family Residences* (FRB).

At the same time, the rate of saving has been declining due to an increase in asset value[12]

[12] Martin Feldstein, President of the National Bureau of Economic Research (NBER), indicates two reasons for the decline in the household savings rate over the past 10 years: (a) an expansion of consumption and beginning of dissaving as a result of an increase in the prices of assets, including stocks and housing, and (b) an increase in household loan refinancing and an increase in cash flow to households as a result of the lowering of interest rates. Based on this, a double-digit annual rate of increase in stock prices and housing prices cannot be expected in the near future, and the mortgage interest rate has already stopped falling. For these reasons, the increase in asset prices and the low interest rate have been promoting personal consumption expenditure over the past several years, and it is pointed out that this will

(Figure 1-2-16). In order to balance the IS balance, it is important to boost the saving rate in the household sector.

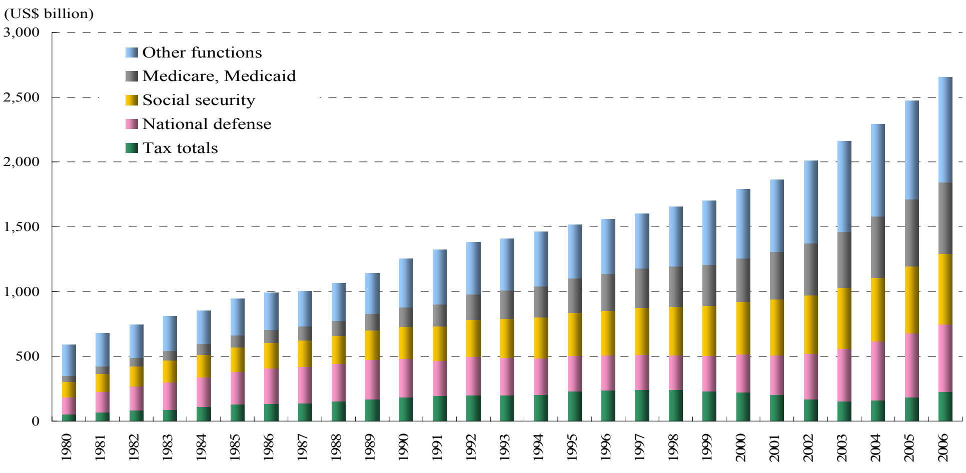
Figure 1-2-16 Changes in the US mortgage and savings rate



Source: Website of the Bureau of Economic Analysis, Department of Commerce,USA and *Flow of Funds Accounts* (FRB).

Meanwhile, the decrease in the margin of deficit has been limited in spite of increased tax revenue from 2004 onward in the government sector, due to factors such as a lowering of income tax and an increase in national defense resulting from the fight against terrorism, and the margin of deficit has remained at a high level in recent years. Spending related to social security is also expected to increase in the future, so there is a need for efforts aimed at further balancing fiscal revenue and expenditure in the United States (Figure 1-2-17 and Figure 1-2-18).

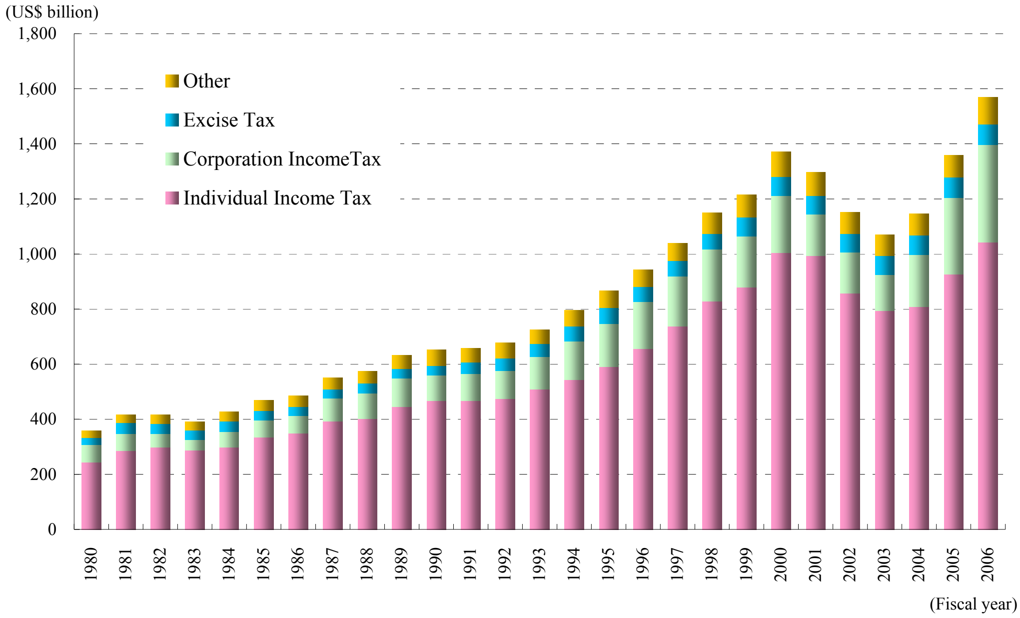
Figure 1-2-17 Changes in annual government outlays of the US administration



Source: Website of Congressional Budget Office (CBO), USA.

no longer continue as a factor behind lowering saving rate . The result is stated as, “This suggests that there will be a relatively rapid rise in the saving trate.”

Figure 1-2-18 Changes in annual government receipts of the US administration
(except social security)

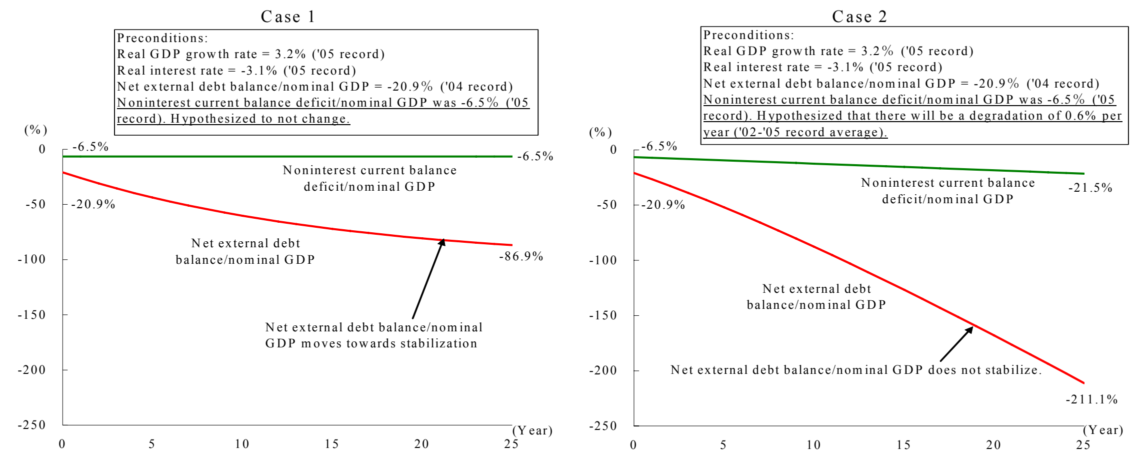


Source: Website of Congressional Budget Office (CBO), USA.

[Column 1] The necessity to improve the external balance of the United States

As was mentioned in 2. (3), in order to stabilize the net external debt balance as a percentage of nominal GDP, it is important to reduce the current account deficit. If the current account is not improved, the net external debt balance of the United States will continue to grow, and there are concerns that this will no longer be sustainable at some point in time. It is anticipated that in order to avoid this type of situation, by reducing the current account deficit to a certain degree, the increase in the net external debt balance as a percentage of nominal GDP will be decreased and there will be a movement toward stabilization[13] (Column Figure 1-1).

Column Figure 1-1 Stabilizing simulation of net external debt balance of the US

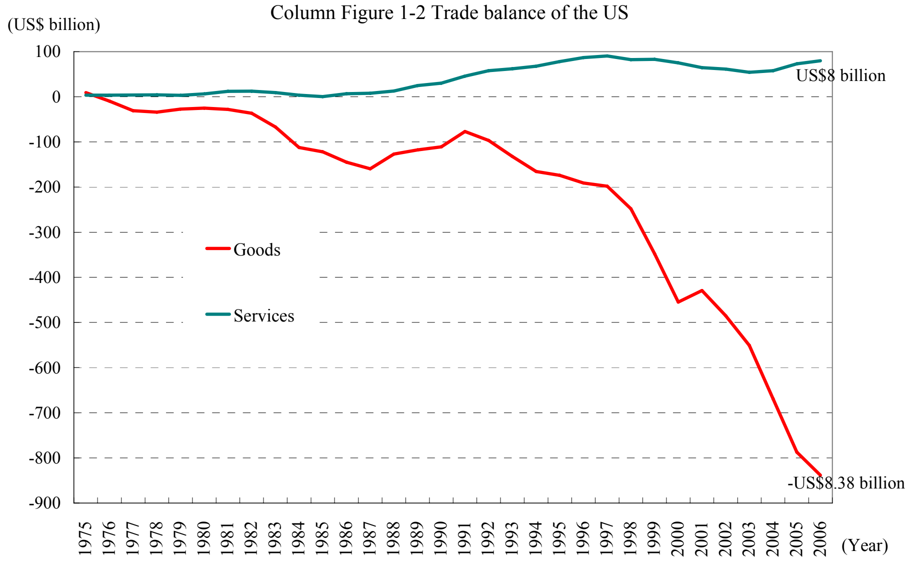


Source: Website of Bureau of Economic Analysis, Department of Commerce, USA, compiled by METI.

13 For details, refer to Attachment 1-2.

The United States has a deficit in goods trade, but it has had a surplus in services trade. Nevertheless, the margin of surplus has remained flat since the latter half of the 1990s, and it has not been enough to constrain the expansion of the trade deficit (Column Figure 1-2). Going forward, it is anticipated that moving forward with regulatory reforms in various countries in the area of services, where there are more trade barriers and restrictions compared to the area of goods, will lead to further expansion of the surplus in the balance on services of the United States, which has a high degree of international competitiveness in many service areas, such as finance, accounting, and IT services, and this will realize a reduction of the trading deficit.[14]

Column Figure 1-2 Trade balance of the US



Source: Website of Bureau of Economic Analysis, Department of Commerce, USA.

(2) Structural reforms required of oil-producing countries

Oil-producing countries continue to have current account surpluses, and are one of the regions that are carrying out the provision of funds to the United States through petrodollar. Looking at the IS balance of oil-producing countries, investment continues to be sluggish and savings continue to increase, so there is a state of excess savings (Figure 1-2-19).

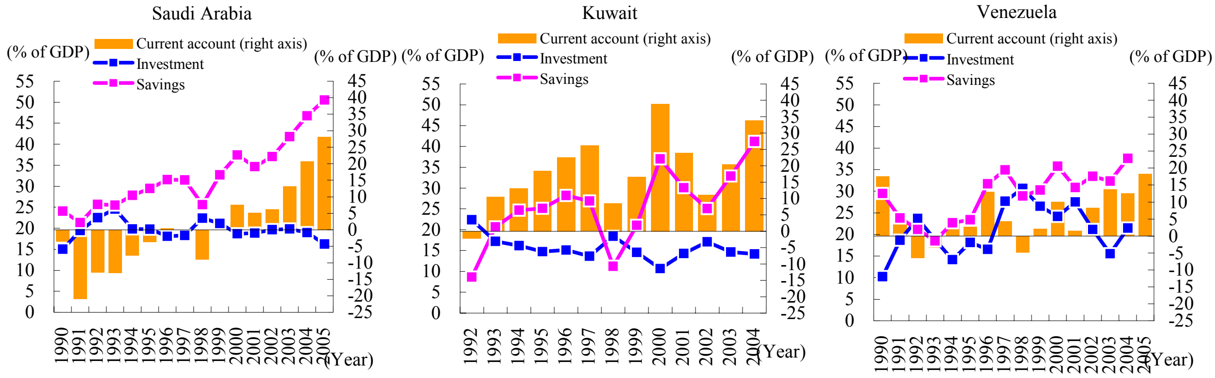
“Report to Congress on international Economic and exchange Rate Policies” by the US Department of the Treasury (May 2006) points out that in eliminating the imbalance of the global current account, it is important to support the strong growth of the global economy by carrying out the following measures: (a) increasing investment in oil production equipment, (b) increasing sensible

[14] In the “Economic Report of the President (February 2007) “, it is forecast that the income that the United States will acquire through the removal of tariff barriers in the areas of agriculture and manufacturing industries will be more than US$16 billion per year. Meanwhile, it is said that regarding the area of services, many service trade barriers still remain in the world, and it is forecast that the income that the elimination of these will bring about for the United States will supposedly be more than US$575 billion per year (4.3% of GDP).

spending for boosting potential economic power and economic diversification, and (c) appropriately strengthening macroeconomic policies and financial policies, including the greater flexibility of currency exchange. The above mentioned policies are thought to be effective in equilibrating the IS balance through increasing investment and consumption, and there is a need for oil-producing countries to contribute to adjustment the global current account imbalance through structural reforms.

Given that oil-exporting countries will continue to have considerable power to acquire foreign currencies, bringing about the smooth back-flow of foreign currencies acquired will continue to be an important issue. The expansion of Islamic finance is important from following perspective: boosting understanding regarding Islamic finance in various countries, and boosting consistency with European and US financial and capital systems.

Figure 1-2-19 Changes in current account and IS balance of oil producing countries



Source: *WDI* (World Bank).

[Column 2] Islamic finance

Islamic finance is the generic term for financial transactions that conform to the doctrine of the Islamic religion (Islamic law = Sharia). Its most prominent characteristics are the fact that in financial transactions, interest is not received or paid, and the fact that transactions comply with the doctrine of the Islamic religion, including parties such as business partners not being involved in businesses that go against the doctrine of the Islamic religion (gambling, weapons, alcohol, pork, etc.).Whether transactions comply with the doctrine of the Islamic religion, authorization must be received in advance from a committee of Islamic scholars (Sharia board), which is set up at each financial institution that provides Islamic financial services.

(Mechanism of Islamic finance)

The financial products that Islamic financial institutions provide are wide-ranging and generally include the equivalents of deposits, insurance, loans, leases, trade and project finance, bonds, and investment funds. In Islamic finance, as mentioned above, the receipt and payment of interest is not included, so as a substitute, revenues from the operation of investments are returned as a dividend to investors such as financers and depositors, and commissions and so forth are paid to financial institutions in exchange for the procurement of goods. Advantages of Islamic finance for the borrowing side which are pointed out are that generally (a) compared to ordinary finance, there is a tendency for procurement costs to be relatively lower, since it is a finance scheme which incorporates the funds of Muslims who prefer operations that conform to the doctrine of the Islamic religion, and (b) it is readily accepted religiously among Muslims, since the origin of funds and method of borrowing comply with the doctrine of the Islamic religion.

Meanwhile, factors behind the increase in entities offering funds include: (a) the ability to contribute to the development of the Islamic world through the fund business activities and so forth, besides funding operations that are in compliance with the doctrine of the Islamic religion, and (b) an increased sense of security for entities offering funds, particularly in recent years, resulting from progress being made in terms of transparency and governance in Islamic finance, as business practices based on general finance are becoming common, partially due to the efforts of major international financial institutions.

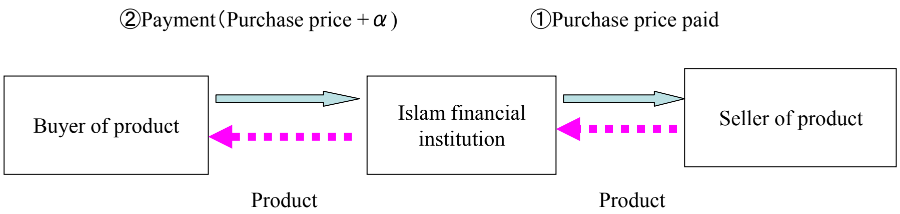
The three representative forms of transaction in Islamic finance—murabaha, mudaraba, and musharaka—are covered below.

• Murabaha

Murabaha is a purchase representation agreement in which, instead of "purchasing goods upon carrying out the procurement of funds," which is carried out in ordinary finance, a provider of funds purchases goods on behalf of a demander of goods and resells them with the addition of a cost.

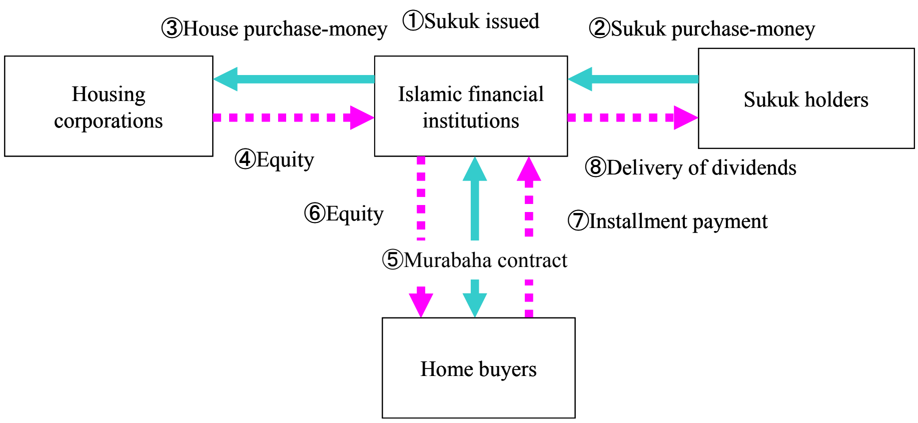
In the case of a simple murabaha, an Islamic financial institution first purchases the goods from the seller, such as products and equipment, which the buyer wants to purchase. After acquiring ownership, the Islamic financial institution adds a cost, and resells the goods to the buyer, who is the customer of the bank. The buyer, based on conditions for payment, including period of grace and payment in instalments, pays the entire cost, adding to the price at which the bank purchased the goods from the seller. It is a transaction concept, which is widely and generally used, as a method of fund procurement aimed at specific goods (Column Figure 2-1).

Column Figure 2-1 The mechanism of Murabaha



A conceptual diagram of a murabaha sukuk, which is a fund procurement scheme in which the murabaha method above is securitized, is shown below (Column Figure 2-2). "Sukuk," which is often translated as "Islamic bond," is the representative product in Islamic financial and capital markets. With general bonds, the coupon portion is considered to be the interest, so sukuk are accompanied by investment and goods transactions, and the revenue from these is applied as an equivalent to the coupon. In other words, sukuk are used as a means of payment accompanying sales contracts or a means of fund procurement for investment operations.[15]

Column figure 2-2 The mechanism of Murabaha (home sales example)



Notes: The Sukuk dividend source is the difference of the price between house purchase-money of Islamic financial institutions and price that the home buyer pay the Islamic financial institutions. The Sukuk holders receives dividends every month, and get the face value equivalent as redemption money at the expiration of the term.

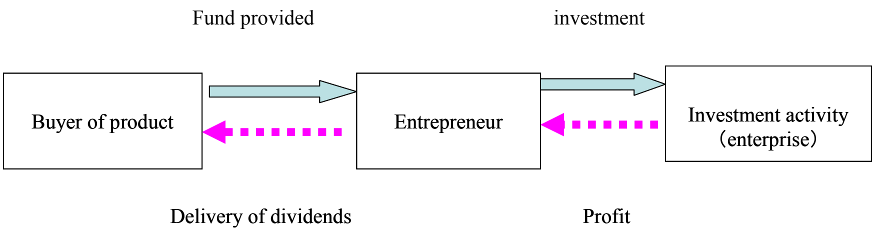
• Mudaraba

Mudaraba can be looked at as a trust financial agreement in which a provider of funds entrusts funds to an entrepreneur who can be trusted. The provider of funds obtains profits generated through the operation of the funds provided as a dividend, in accordance with an agreement regarding the ratio of revenue allocation. In the case that a loss is incurred in the operation, the provider of the funds undergoes all of the loss (Column Figure 2-3).

Even in the case that a business ends with no success, as long as the entrepreneur is not guilty of negligence or violations, the entrepreneur not responsible for the funds received. Meanwhile, it is not joint management, so the provider of the funds is only has responsibility within the scope of the amount of the funds provided. Sukuk mudaraba is a method in which a financial institution mediates between the provider of funds (investor) and an entrepreneur in cases such as when it is difficult for a provider of funds (investor) to directly find a promising entrepreneur.

15 Holders of sukuk are not holders of simply a hypothecated asset; they have rights as a party of the original agreement.

Column figure 2-3 The mechanism of mudaraba

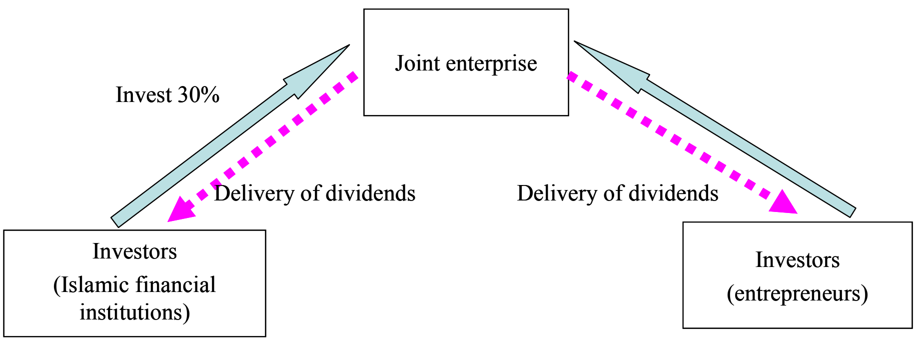


• Musharaka

Musharaka, which is a type of investment finance, is a scheme in which an investor of funds and an entrepreneur carry out joint management of a business, besides joint capital investments and allocate the profits generated based on a ratio decided at the time of agreement.

Unlike mudaraba, it is borne by both parties in accordance with the investment ratio or a ratio agreed upon in advance even when a loss is incurred in business, and the provider of funds holds the management floor largely in accordance with the investment ratio, as a business partner (Column Figure 2-4).

Column Figure 2-4 The mechanism of Musharaka



(Rapid growth of Islamic finance)

There are no international official statistics regarding the market size of Islamic finance, but financial institutions that provide Islamic financial services are operating in around 40 countries in the world, and the number of these institutions are estimated that there are 265 such institutions[16]. Their total assets is estimated up to US$400 billion[17].

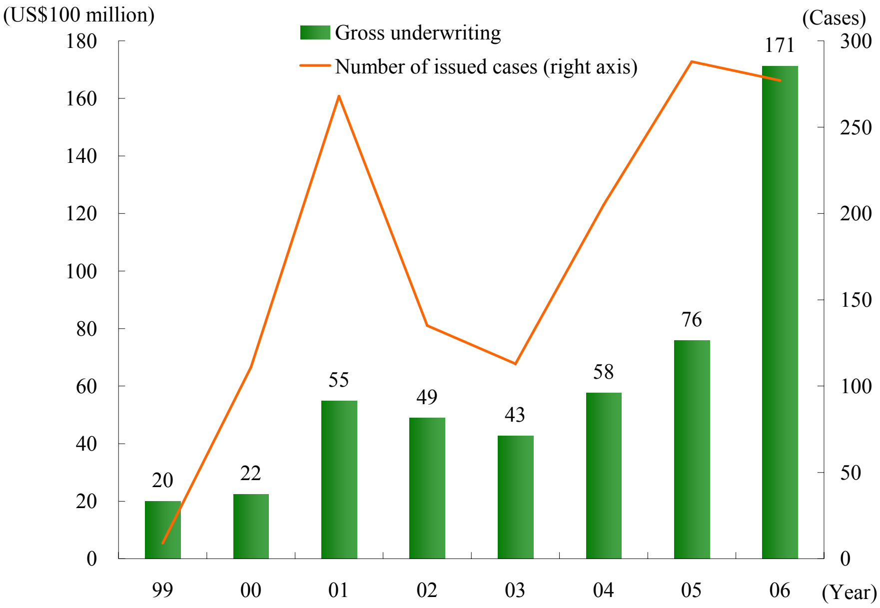
Recently, European and US financial institutions which have focused attention on profit-earning opportunities connected with the enormous amount of petrodollar and which have carried out international business expansion are becoming more active in Islamic financial business in a wide range of areas, including the underwriting of Islamic bonds, Islamic-style fund management, and Islamic-style project finance, in the Middle East and Malaysia and at Islamic financial centers

16 Business Week Online, Aug. 8, 2005.
17 Business Week Online, Oct. 26, 2006.

such as London. Furthermore, the issuance of Islamic bonds is increasing by government agencies, international organizations, and companies in non-Muslim areas such as Western developed countries. The International Monetary Fund (IMF), World Bank, and so forth are also strengthening efforts in surveys, support, and other aspects in regard to Islamic finance.

As a result, the total underwriting amount of Islamic bonds, which was no more than US$2.2 billion in 2000, more than doubled in 2001 to US$5.5 billion and further increased to US$17.1 billion in 2006 (Column Figure 2-5).

Column Figure 2-5 Changes in amounts of underwriting issued by Islamic Organizations



Source: Bloomberg.

(Backdrop to the growth of Islamic finance)

The following types of changes to economic and social conditions are pointed out as being behind rapid growth of Islamic finance. Namely, especially in oil-producing countries in the Middle East, these include: (a) an expansion in surplus funds due to increased oil revenues resulting from high oil prices (Column Table 2-6), (b) an expansion in investment fund demand in new projects, such as oil refining equipment and the construction of infrastructure, accompanying the increase in oil revenues, (c) the interpretation of back-flow of a portion of the funds of oil-producing countries, which were invested in the United States, and have shifted to Europe and a considerable amount homeward to the oil-producing countries after the terrorist attack on the United States on September 11, 2001[18], (d) an increase in the establishment, spread, and degree of awareness of systems of Islamic finance in Islamic countries, and (e) an increase in the consistency of Islamic finance with

[18] It has been reported that in terms of the private-sector funds of Saudi Arabia alone, US$100 billion to US$200 billion of assets were withdrawn from the United States. (The Financial Times, Aug. 20, 2002)

international standards for financial services.[19]

Column Table 2-6 Changes in revenues of oil-producing countries

(Unit: US$ billion)

	2005 estimate	2006 forcast	2007 forcast
Iran	46.6	50.1	46.5
Iraq	23.4	24.9	23.7
Kuwait	39.0	44.1	41.1
Saudi Arabia	153.3	162.0	150.2
Qatar	19.1	23.3	23.0
Indonesia	-1.0	-0.6	-0.9
Libya	28.3	31.2	29.9
United Arab Emirates	45.6	53.0	52.2
Algeria	36.0	41.6	41.1
Nigeria	45.1	52.7	51.1
OPEC members total	473.1	521.9	495.2
Malaysia	6.7	7.5	8.2

Notes: Announced January 2006.
Source: Website of Energy Information administration, Department of Energy

(Efforts in Islamic finance by Japanese companies)

Recently, cases of the Issuing of Islamic bonds by Japanese companies and financial institutions have been increasing.

The Japan Bank for International Cooperation (JBIC) became the first Japanese organization to become an observer member of the Islamic Financial Services Board (IFSB) in January 2007, an international organization of Islamic finance. In January as well, JBIC concluded a memorandum on operation cooperation in regard to Islamic finance with the Central Bank of Malaysia. Since last year, JBIC has been carrying out surveys and information gathering regarding the issuance of Islamic bonds.

Company A, a major distribution-type financial company, announced that its local corporation in Malaysia would procure funds by floating Islamic bonds (sukuk) in January 2007, which are the bonds of Islamic finance. This is the first bond issuance by a Japanese company incorporating the method of Islamic finance, and the fund procurement of a total amount of 400 million ringgit (approximately 13.6 billion yen) is set to be utilized as investment and operating funds aimed at local business expansion. Company A in 2002 started consumer finance based on the method of Islamic finance, and among Japanese companies started carrying out efforts in Islamic finance relatively early.

(Challenges in Islamic finance)

A certain degree of success has been achieved in aligning and harmonizing the strict

[19] The Islamic Financial Services Board (IFSB) was established in 2002 with the aim of increasing affinity with international financial markets, issuing bonds from outside Islamic areas, and acquiring investment. In the establishment agreement, an objective is set to "further develop Islamic finance through incorporating international financial service standards in a scope that is consistent with Sharia."

self-regulation that Islamic finance places on investment and loan behavior based on the doctrine of the Islamic religion, including the prohibition of interest, with the financial and capital market systems of the non-Islamic world, and this has contributed to the expansion of finance in Islamic areas. Nevertheless, in order for Islamic finance to further develop in the future, there are challenges which need to be tackled.

For example, these include the following. (a) The interpretation of various financial transactions based on the doctrine is basically left to respective scholars, so the interpretation of a single financial transaction may differ among scholars and Sharia boards. There are also trends according to region, and it is often the case that interpretations are strict in the Middle East and flexible in Malaysia. Therefore, problems are taking place such financial institutions being divided on whether a certain transaction is right or wrong and it requiring long periods of time to receive approval.[20] (b) As Islamic finance, which has religious restrictions on loan behavior, continues to steadily expand in size, problems are arising in terms of how to balance points of rationality and religion which are sometimes in conflict. (c) Human resources that have a combination of specialized knowledge regarding both the Islamic religion and financial technologies and markets, which are needed to support Islamic financial business, are mostly lacking, and it is necessary to foster such human resources.

Islamic finance has shown rapid expansion against the backdrop of the Islamic world, which has many oil-producing countries under its influence and is said to have a population of 1.3 billion people worldwide,[21] possessing huge amounts of financial assets as a result of the expansion of oil export revenues in recent years. Islamic finance is occupying a gradually increasing share in the international financial market, and there are increasing expectations of Islamic finance as a new channel for the smooth back-flow of funds, such as petrodollar, to the United States and so forth. These challenges should be thoroughly addressed and sound development of Islamic finance should be achieved.

(3) Toward the expansion of domestic demand in China, ASEAN4, and NIEs

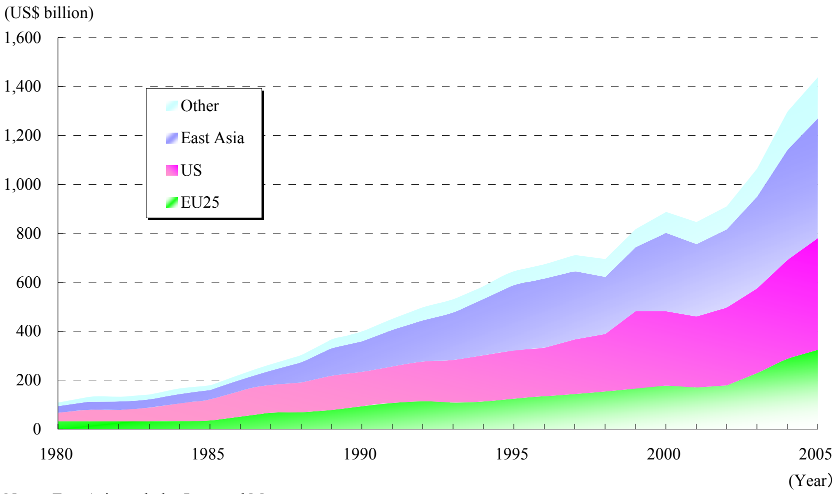
(Export-led economies of China, ASEAN4, and NIEs)

China, ASEAN4, and NIEs export a great deal of ultimate consumer goods that they have produced to the United States and other areas outside of East Asia region, and there is a need for the expansion of consumption within the East Asia region (Figures 1-2-20, 21, 22, 23, 24).

[20] With regard to this point, current the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which was jointly established by Islamic financial institutions, is working to create uniform standards, while receiving support from the International Monetary Fund (IMF).

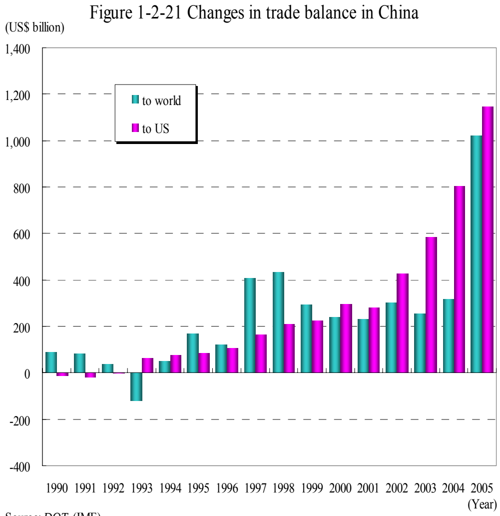
[21] Central Intelligence Agency (CIA) (2007), The World Factbook.

Figure 1-2-20 Final destination of the ultimate goods from East Asia



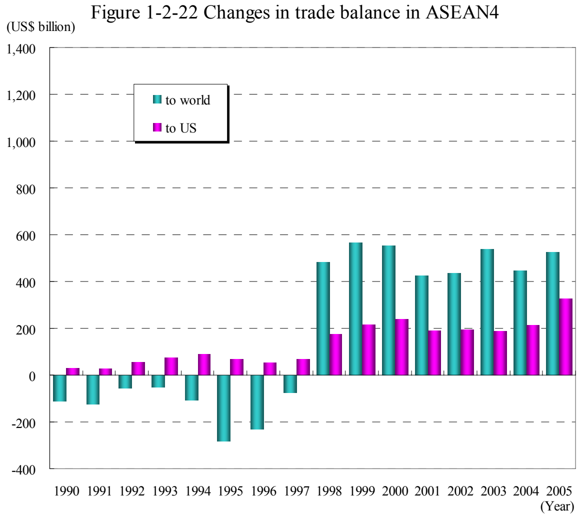
Notes: East Asia excludes Laos and Myanmar.
Source: *RIETI-TID2006* (Research Institute of Economy, Trade, and Industry).

Figure 1-2-21 Changes in trade balance in China



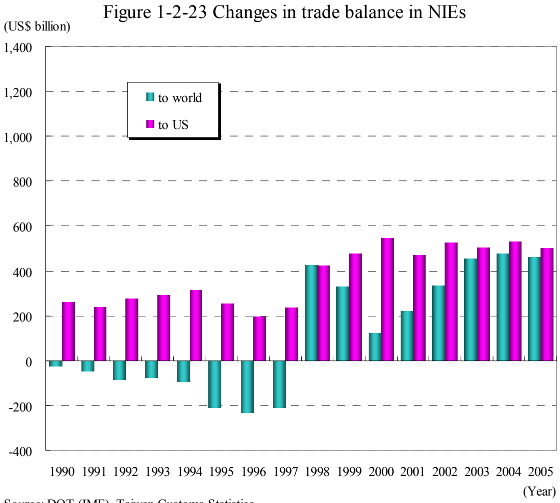
Source: *DOT* (IMF).

Figure 1-2-22 Changes in trade balance in ASEAN4



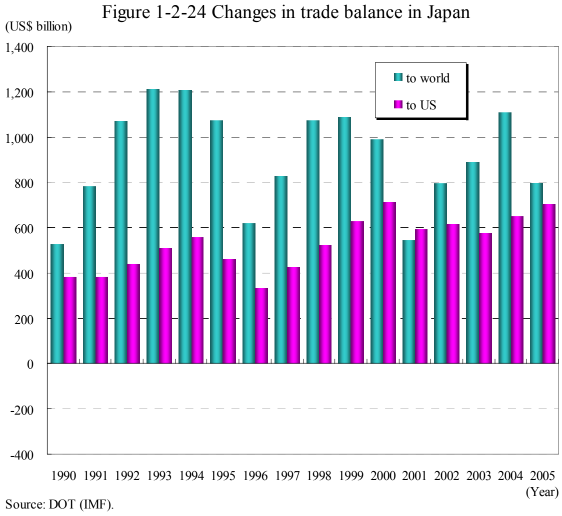
Source: DOT (IMF).

Figure 1-2-23 Changes in trade balance in NIEs



Source: DOT (IMF), Taiwan Customs Statistics.

Figure 1-2-24 Changes in trade balance in Japan



Source: DOT (IMF).

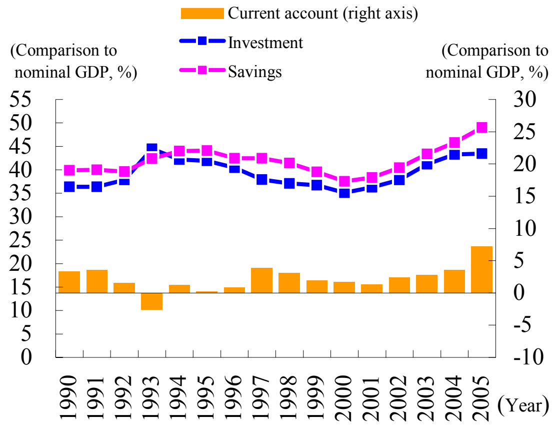
(IS balance of China, ASEAN4, and NIEs)

The global current account imbalance is a manifestation of the IS balance of countries in the world, starting with the surplus in the IS balance (excess savings and insufficient investment) of China, ASEAN4, and NIEs. Accordingly, China, ASEAN4, and NIEs need to make efforts toward expanding imports through an expansion of consumption and equilibrating the IS balance through an expansion of investment.

Looking at changes in savings and investment and the current account in China, ASEAN4, and NIEs, it can be pointed out that there are significant excess savings and a current account surplus in for the most of these regions and countries.

China: With GDP growth that has been above 10% from 2002 onward, investment has been increasing rapidly, and it reached the high level of 44% of GDP in 2005. Nevertheless, savings have continued to grow more than investment, and as a result, savings amounted to 47% of GDP in 2005, and a situation of excess savings is continuing. The result of this is that China's current account surplus has continued to expand, and it amounted to greater than 7% of GDP in 2005 (Figure 1-2-25).

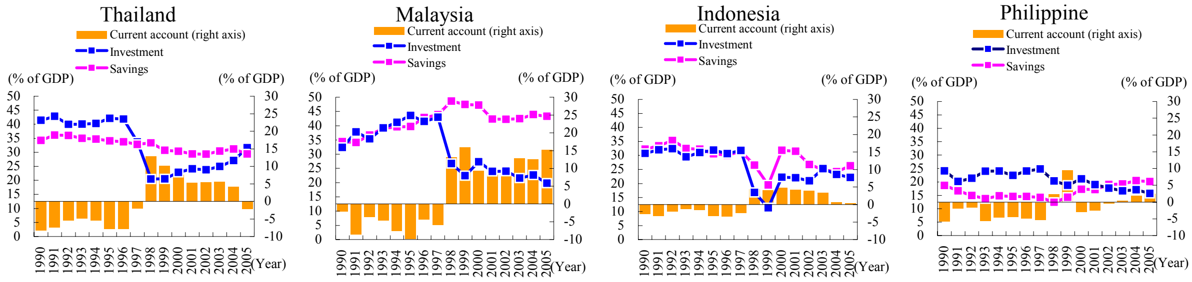
Figure 1-2-25 Changes in current account and IS Balance of China



Source: *WDI* (World Bank).

ASEAN4: In Indonesia, where the recovery of investment has been slow after the Asian currency and financial crisis in the end of 1997, as a result of the progressive decline in savings from 2001 onward, the current account was more or less zero in 2005. Malaysia, where sluggish investment continued after the Asian currency and financial crisis, has continued to see a significant current account surplus of over 10% of GDP since 1998. Thailand, where investment showed a notable recovery subsequent to rapidly falling immediately after the Asian currency and financial crisis, saw investment excess in 2005, and its current account shifted to a deficit (Figure 1-2-26).

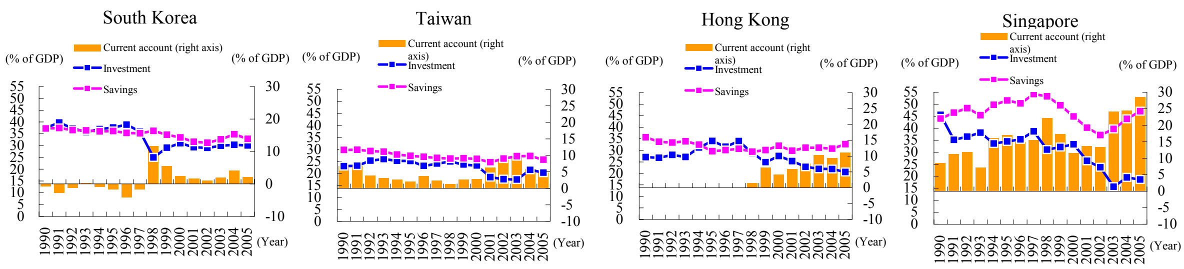
Figure 1-2-26 Changes in current account and IS balance of ASEAN countries



Source: *Key Indicators 2006* (ADB).

NIEs: Singapore has showed significant excess savings and a current account surplus, with a particularly notable decline in investment. Investment is also continuing to decline in Hong Kong, and there continues to be a current account surplus. Moreover, in South Korea, investment, which showed signs of a temporary recovery after the Asian currency and financial crisis, subsequently continued to be flat, and a situation of excess savings and a current account surplus has been continuing. In Taiwan, with both savings and investment remaining flat, a situation of excess savings and a current account surplus has been continuing (Figure 1-2-27).

Figure 1-2-27 Changes in current account and IS balance of NIEs countries



Notes: Hong Kong's current account data is from 1997 onward.
Source: *Key Indicators 2006* (ADB), Hong Kong from *WDI* (World Bank).

(Reference)

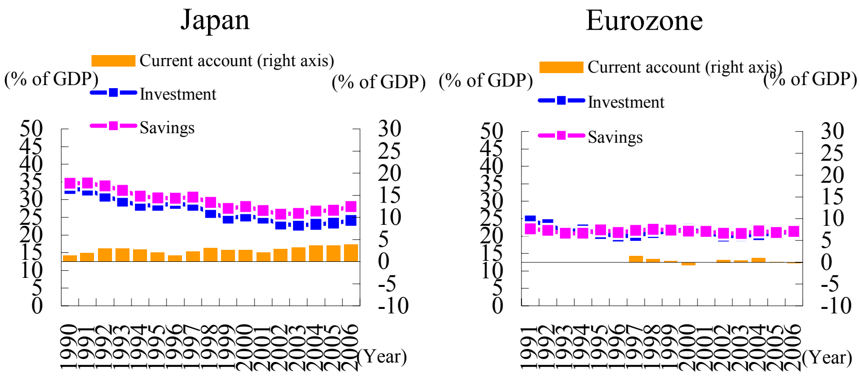
Japan: While there has been a notable decline in household savings against the backdrop of the sluggish economy and rapidly aging population, the decline in investment has been progressing at a greater pace, and the situation of excess savings from the 1990s has continued and expanded. As a result, the current account surplus has continued to expand, and reached 3.9% of GDP in 2006.

Eurozone: The IS balance has for the most part been kept in equilibrium, and the current account has remained in the proximity of zero[22] (Figure 1-2-28).

---

[22] Looking at the trends of the 12 countries that make up the Eurozone as of 2006, six countries, including Germany (current account surplus of 1.2% of GDP in 2005) and the Netherlands (current account surplus of 0.5% of GDP in 2005), have current account surpluses, while six countries, including Spain (current account deficit of 0.8% of GDP), Italy (current account deficit of 0.3% of GDP), and France (current account deficit of 0.3% of GDP) had a current account deficit. It is thus not the case that the respective member countries have current accounts in equilibrium.

Figure 1-2-28 Changes in current account and IS balance of Japan and Euro zone countries

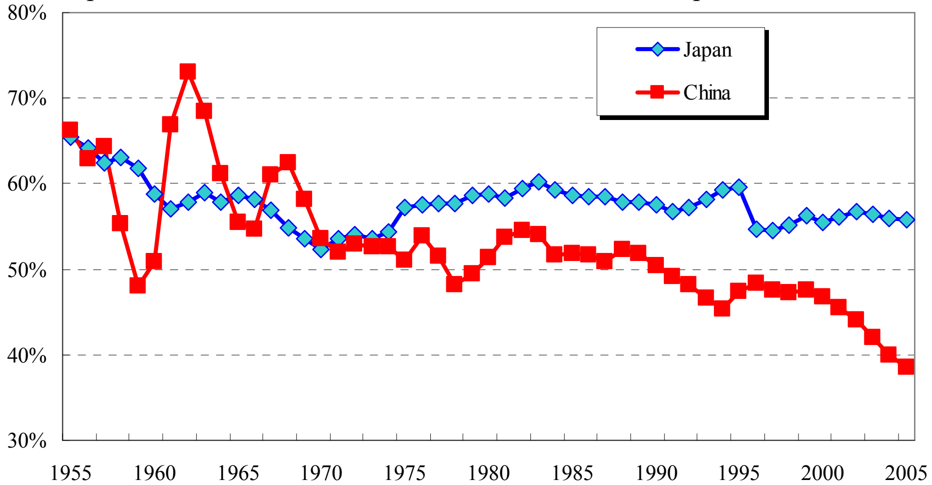


Note: Eurozone consists of 13 countries. Data for current account balance starts from 1997.
Source: *WEO* (IMF).

(Expansion of consumption in China, ASEAN countries and NIEs countries)

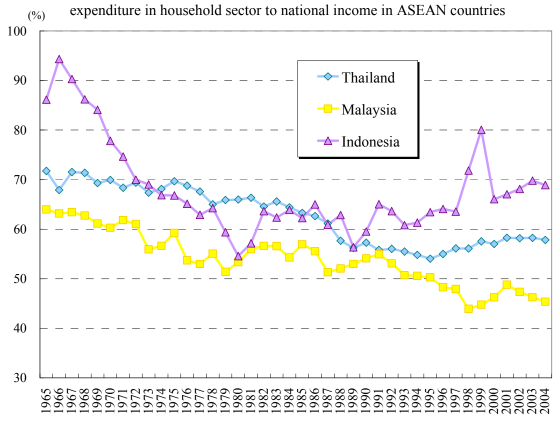
In China, ASEAN countries, and NIEs countries, the growth of consumption has been small relative to economic growth. Looking at this in terms of final consumption expenditure of households as a percentage of national income, it has been flat or in a downward trend, and the expansion of consumption is an important issue (Figures 1-2-29, 30, 31).

Figure 1-2-29 Changes in proportions of final ultimate consumption expenditure in household sector to national income in Japan and China



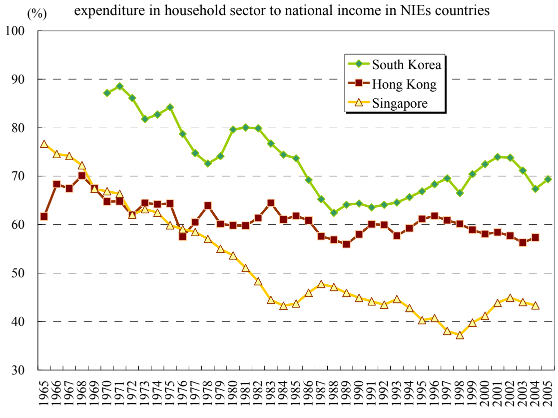
Source: National Accounts (Cabinet Office, Japan), CEIC Database. (Year)

Figure 1-2-30 Changes in proportions of ultimate consumption expenditure in household sector to national income in ASEAN countries



Source: *WDI* (World Bank), CEIC Database.

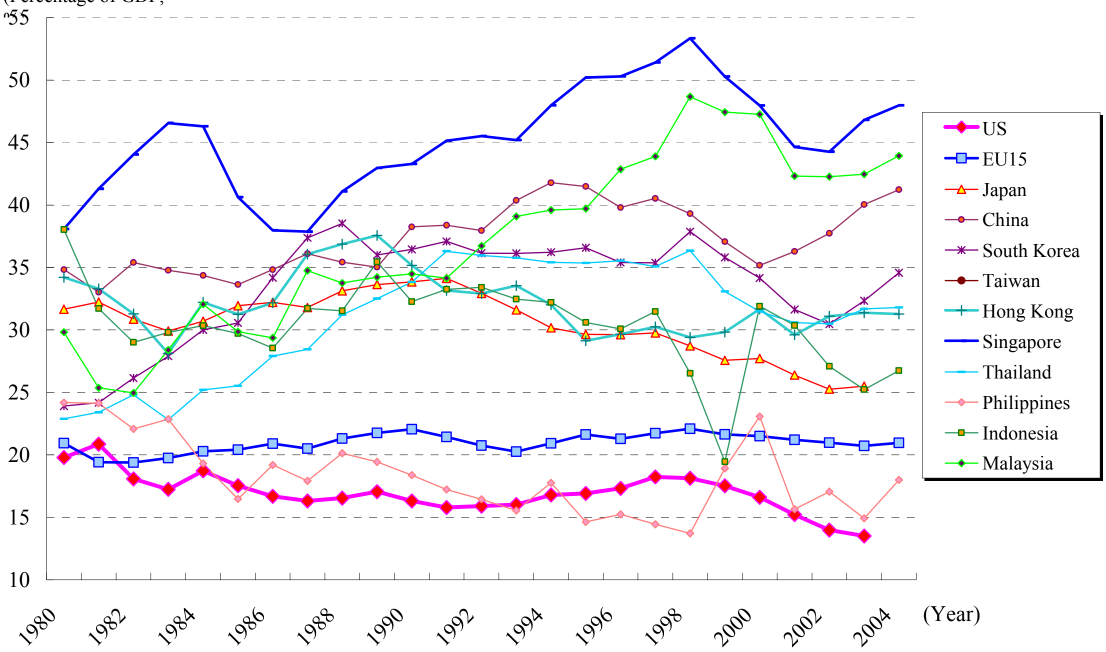
Figure 1-2-31 Changes in proportions of ultimate consumption expenditure in household sector to national income in NIEs countries



Source: *WDI* (World Bank), CEIC Database.

It is pointed out that personal consumption in China, ASEAN countries, and NIEs countries is low because social security has not been sufficiently developed, so there is anxiety about the future, and people are saving more than they are consuming. In fact, the savings rates of China, ASEAN countries, and NIEs countries (excluding the Philippines) are generally at high levels compared to those of Europe and the United States (Figure 1-2-32). The enhancement of social security systems, the further enhancement of employment stabilization policies, increases in national income through economic growth, and increases in labor distribution rate, so forth are expected to lead to the expansion of consumption in these regions going forward(Table 1-2-33).

Figure 1-2-32 Changes in gross domestic savings rate in nominal GDP of major countries



Source: *WDI* (World Bank).

Table 1-2-33 Consumption related indexes in major countries

(percentage of nominal GDP, %)

	Personal disposable income	Tax on Personal income *1	Personal consumption/ disposable income	Personal consumption	Public consumption	Labor income	Government consumption on health and education *2
US	74	9	95	70	16	57	22
UK	66	10	98	65	21	56	13
Australia	58	12	103	60	18	49	15
Canada	58	12	96	56	19	50	16
Ireland	49	-	91	44	14	40	12
France	62	8	90	56	24	52	16
Germany	66	9	88	57	19	51	16
Italy	67	-	90	60	20	42	14
Japan	59	8	96	57	18	51	12
China	60	1	69	41	10	56	3
India	84	2	76	67	11	-	-
South Korea	54	3	95	51	13	44	14
Singapore	52	2	82	43	11	-	-
Taiwan	73	3	77	60	14	47	-
Thailand	65	2	87	57	10	30	6
Philippines	78	3	89	69	10	34	5
Hong Kong	-	-	-	-	10	-	-
Malaysia	-	-	-	-	13	-	10
Indonesia	-	-	-	-	8	-	2

Notes: 1. 2003 Data
2. 2001 Data

Quoted by: *Regional Economic Outlook September 2006* (IMF)
Original Source: OECD, CEIC Database, IMF.

(Expansion of investment in China, ASEAN4, and NIEs)

The promotion of economic integration through the development of an investment environment and reduction of disparities in East Asia and so forth is expected to lead to the expansion of investment in the region.

(Efforts required of each country)

As has been looked at so far, if the current account imbalance is left unadjusted, there is a possibility that risks will develop for the world economy as a whole, including continued expansion of the net external debt balance of the United States.

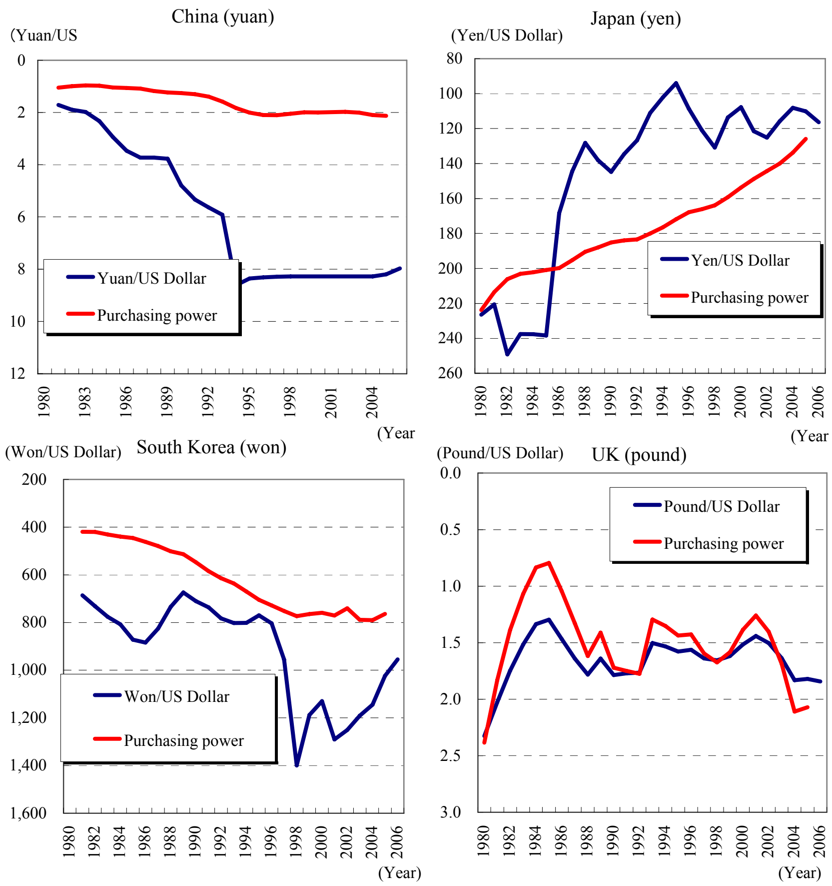
China has brought about a net increase in foreign exchange reserves of approximately US$200 billion or greater per year based on a rigid currency exchange rate system. While China needs to accelerate reforms for more flexible exchange rates for sound domestic macroeconomic management, making exchange rate level adjustments to the exchange rate level itself has a limited role in reducing this type of IS balance, and there cannot be expected to be a significant reduction in the current account imbalance. Even if reduction in this regard is carried out focusing on the current account imbalance with a particular country, unless the IS balance is adjusted, the current account imbalance with other countries will only expand unless the IS balance is adjusted,. In order to reduce the global current account imbalance, it is essential to move forward with efforts for reducing the imbalance of the IS balance, in order for the domestic macro-economies in each country to develop in a more balanced and sound manner (Figure 1-2-34 and Figure 1-2-35).

Table 1-2-34 Policies listed in various statements towards adressing global imbalances

	Statement by G-7 Finance Ministers and Central Bank Governors (Annex: Global Imbalance)	13th APEC Finance Ministers' Meeting Joint Ministerial Statement	Communique of International Monetary and Financial Committee (IMFC) of the Board of Governors of International Monetary Fund
	April 21, 2006	**Sept. 7-8, 2006**	**Sept. 17, 2006**
USA	Further action is needed to boost national savings by continuing fiscal consolodation, addressingm entitlement spending, and raising private saving.	Greater national savings.	Steps to boost national saving, including fiscal consolidation.
Europe	Further action is needed to impliment structural reforms for labor market, product, and services market flexibility, and to encourage domestic demand led growth.	Stronger domestic demand growth.	Further progress on growth-enhancing reforms.
Japan	Further action is needed to ensure the recovery with fiscal soundness and long-term growth through structural reforms	Further structural reforms including fiscal consolidation.	Further structural reforms, including fiscal consolidation.
Emerging Asia	(Particularly China): Greater flexibility in exchange rates is critical to allow necessary appriciations, as is strengthening domestic demand, lessening reliance on export-led growth strategies, and actions to strengthen financial sectors.	Greater exchange rate flexibility for some economies as approproate.	Reforms to boost domestic demand, together with greater exchange rate flexibility in a number of surplus countries.
Others	*Oil-producing countries* : accelerated investment in capacity, increased economic diversification, enhanced exchange rate flexibility in some cases. *Other current account surplus countries* : should encourage domestic consumption and investment, increase micro-economic flexibility and improve investment climates.	*In other APEC member economies* : Stronger domestic demand growth.	*Oil-producing countries* : Increased spending consistent with absorptive capacity and macroeconomic stability.

Source: Ministry of Finance website, compiled by METI.

Figure 1-2-35 Changes in exchange rates of respective currencies against dollar as well as purchasing power parity



Source: *WDI* (World Bank), Bloomberg.