

## **Chapter 1 Current and Future Status of the Global Economy in Transition**

### **Section 1 : Current status of the global economy and movement to alter its structure**

#### **2. Issues and Handling of the International Economic Framework Which Became Clear Because of the Global Economic Crisis – Diversification of the Global Economy –**

It has become clear after the Leh Brothers problem and the global economy directly facing a critical junction that unresolved issues in the global economic framework exist.

At the G20 Washington Summit held in November 2008, vulnerabilities in the financial system were pointed out as the fundamental cause of the crisis occurring<sup>60</sup>.

As for the increasing pressure for protectionism after the crisis, countries which are members of the WTO, including G20 members, are committed to avoiding trade protection measures<sup>61</sup>. Although using protectionist measures is not clearly against the existing rules, there are no shortage of countries which implement trade protection measures<sup>62</sup>.

In order for deep-rooted, balanced and sustainable growth to occur in the global economy, it is said that a correction of the global imbalances is needed and there has been international agreement by the G20 on the framework that needs to be created for this to occur<sup>63</sup>. After the global economic crisis occurred there was a remarkable imbalance in the current balance of payments throughout the world which was in the process of adjusting but international cooperation to correct the imbalance is expected.

The following are the central issues of the global economy which have come to light due to the global economic crisis and will be explained further: 1. correction of the global imbalance, 2. sound global financial system and, 3. prevention of protectionism in the framework of global trade.

#### **(1) Rebalancing of the global imbalance**

According to the IMF, the global imbalance is the pattern seen in the global economy after the end of the 1990's between the current account surplus and current account deficit<sup>64</sup>. More specifically, it designates places such as the United States, United Kingdom, Southern Europe (Greece, Italy, Portugal and Spain) and Central and Eastern Europe as having large current

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<sup>60</sup> In the "Summit Declaration on Finances and the Global Economy" given at the G20 Washington Summit on November 15, 2008, points to the primary reason for the current crisis as, "(financial) market participants not correctly evaluating the risks, seeking high interest rates and a lack of appropriate due diligence. At the same time, weak accepted standards, unsound risk management procedures and increasingly complicated and uncertain financial products and excessive leverage created by these results culminated into the creation of a weak system.

<sup>61</sup> At the "Summit Declaration on Finances and the Global Economy" given at the G20 Washington Summit on November 15, 2008, APEC Leaders Lima Declaration concerning the global economy on November 22 and the declaration by leaders at the G20 London Summit on April 2, 2009 commented that, "new obstacles to the trade of investment, products and services would not be established, new restrictions on exports nor measures to stimulate exports which do not comply with the WTO.

<sup>62</sup> Ministry of Economy, Trade and Industry (2010) 'Report on Unfair Trade' " 3. Trends in various protectionism measures"

<sup>63</sup> Declaration by leaders at the G20 Pittsburg Summit on September 24-25 2009. (Refer to page 26-27 for a summary)

<sup>64</sup> IMF (2009), World Economic Outlook, April 2009.

account deficits and places such as China, Japan, other East Asia countries, Germany and oil exporting countries as expanding their large current account surpluses.

Figure 1-1-2-1 shows the composition of current account surplus and current account deficit countries and regions throughout the world (bar graph) and shows a comparison of the world's current account imbalance (total current account surplus) (line graph). As is shown in this graph, the imbalance was limited to 1% of the world GDP between 1980 and the mid-1990's. However, after 2000, the current account deficit in the United States expanded causing an imbalance in world trade and in 2006 it expanded to 2.5% of global GDP, which was the highest level ever experienced. As a result, the current account deficit in the United States made up 80% of the global account deficit and was centralized and set in this one country (Figure 1-1-2-1)

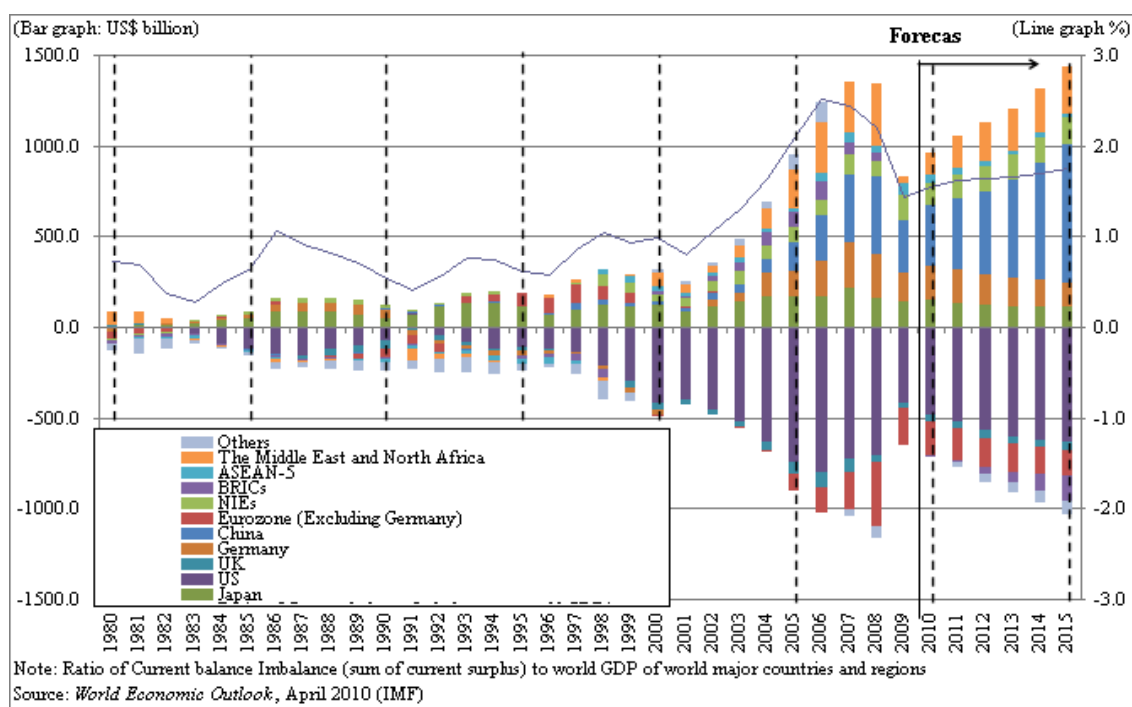
Meanwhile, during the 1990's Japan, Germany and the euro zone made up most of the current account surplus, while during the 2000's, emerging countries such as Middle Eastern oil countries and China were added to Japan and Germany as countries that contributed to the current account surplus. China, one of these countries, after the reform and liberalization in 1979, started actively including components of capitalism such as a market economy, established economic zones and an open door policy to give favorable treatment to overseas companies, and this helped them achieve a higher rate of economic growth. Especially after China was included as a member country in the WTO expanding their trade<sup>65</sup>, China's current account surplus expanded significantly and in 2008 China's current account surplus made up 31% of the global surplus.

After the global economic crisis in 2009 the current account imbalance was 1.4%, rapidly shrinking 0.8% compared to the previous year. The current account imbalance has maintained its high level compared to before 2001 and it is difficult to say that the imbalance has adequately corrected. Also, while the current account deficit of the United States (418 billion dollars) in 2009 was almost the same as it was in 2000 (417 billion dollars), China's current account surplus has increased 14 times from 2 billion dollars to 284 billion dollars and NIEs plus ASEAN5 has grown by 3 times from 6.4 billion dollars to 207 billion dollars. The composition between the current account deficit of the United States and current account surplus of emerging countries such as China is becoming clearer.

**Figure1-1-2-1: Trends of Budget Imbalances of Major Countries/Regions**

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<sup>65</sup> Shiyu Kan (2009) 'China as No. 1' Toyo Keizai



The following paragraphs organize the problems and the history of the unprecedented scale in which the global imbalance has expanded and examines future trends. Various countries efforts to correct the imbalance will also be shown.

### (A) Problems with the global imbalance

The imbalance in the current account balance has always existed historically and the fact that it exists is not bad. As long as borrowing nations can maintain their debt finances there is no problem.

However, if the scale of the imbalance grows larger and the current account deficit is concentrated in one country it becomes more difficult for the borrowing country to maintain its debts. As a result, there are increasing concerns that there will be defaults on debt obligations that will have such a large impact that it will cause wide changes in macro policy. There are also concerns that adjustments in the imbalance will not only be a local problem but will develop<sup>66</sup> into systematic risk<sup>67</sup>.

This global economic crisis is not the first time that the imbalance in the current account balance has become a problem. During the 1980's when the external imbalance grew the disequilibrium in the current account balance was looked at as a global problem<sup>68</sup>. However, the

<sup>66</sup> Systemic risk is the risk of insolvency on the part of individual financial institutions or the malfunctioning of a specific market or settlement system spreading over to other markets or total financial systems. Especially in the case of individual financial institutions, because they can be mutually connected like a web through fund settlements of various transactions and settlement networks, the effects of one insolvency has the risk of spreading like dropping dominos in the blink of an eye through settlement systems or markets.

<sup>67</sup> Ri Tanaka (2010) 'Prospects for the Global Imbalance'.

<sup>68</sup> For example, the Plaza Accord reached in September 1985 states, "we agreed that exchanges rates should play its role in

correction in the current imbalance is thought of as a more serious problem compared to previous imbalances due to the following reasons.

**(a) Scale of the imbalance and size of the impact on the economy**

While the current scale of the imbalance has adjusted from the crisis, the scale of the imbalance is still a great deal larger than during the 1990's compared to GDP and the surplus and deficit nations are firmly fixed. Therefore, there are concerns that a substantial adjustment will occur if the economy experiences another shock.

**(b) Increasing globalization**

Globalization is continuing to occur in both the structure of trade and financial markets. Because of this there are increasing tendencies that if another global economic shock occurs its effects will spread across borders in an instant, even if the incident is limited initially to a certain region.

**(c) Increasing dependency of current account surplus countries on emerging countries**

Up until the 1990's, countries with a current account surplus were mainly comprised of Japan, Germany and other developed countries in the euro zone, but currently most of the current account surplus in the world is made up of emerging countries that require a large amount of funds to grow their economies in the future. In these countries, government agencies such as the central bank are mainly investing in the United States (United States treasury bonds and bonds from organizations) with the purpose of moving into dollar-based exchange reserves. Therefore, emerging countries hold large exchange reserves in government bonds. The share of United States treasury bonds held by emerging countries such as China and Brazil is increasing, and in September 2008, China overcame Japan to be the largest holder of United States bonds in the world. As is shown in the solid line in figure 1-1-2-2, the amount of United States treasury bonds possessed by foreign countries has been rapidly increasing during the 2000's. As shown in figure 1-1-2-3, the percentage of US treasury bonds held overseas after the first quarter of 1995 (19.0%) continued to increase but has started to trend downward after the fourth quarter of 2008 (50.7%). This is thought to be because the rate of possession in the United States is increasing due to an increase in the rate of savings domestically and indicates movement to diversify conventional dollar-based exchange reserves of various countries<sup>69</sup>.

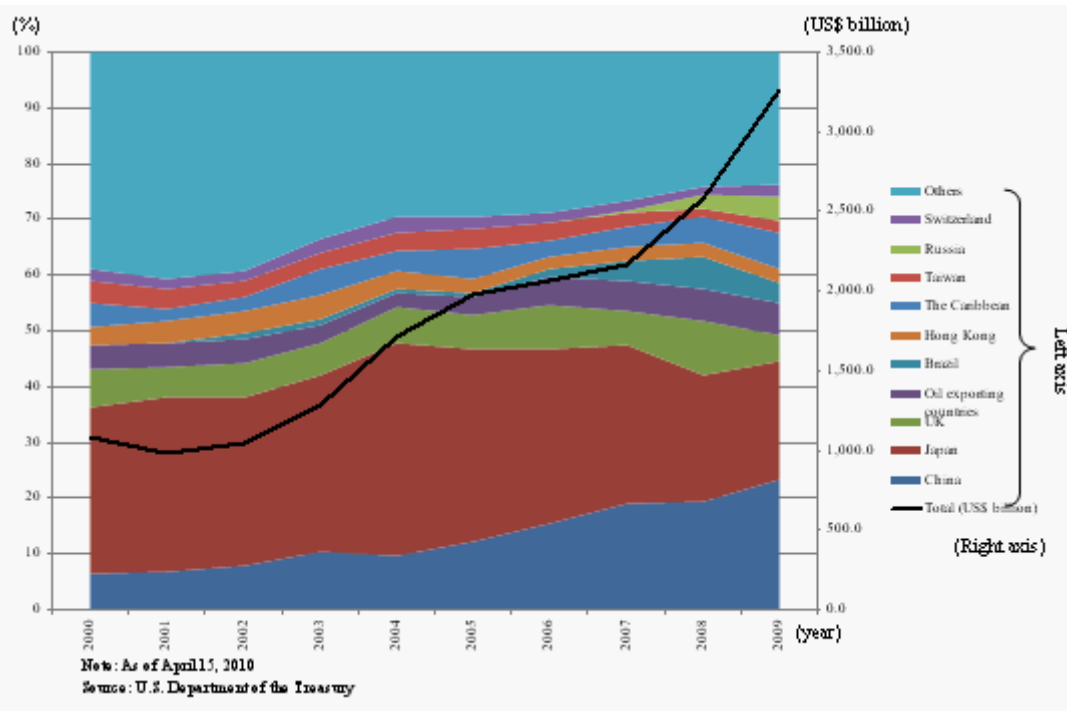
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adjusting the external imbalance.”

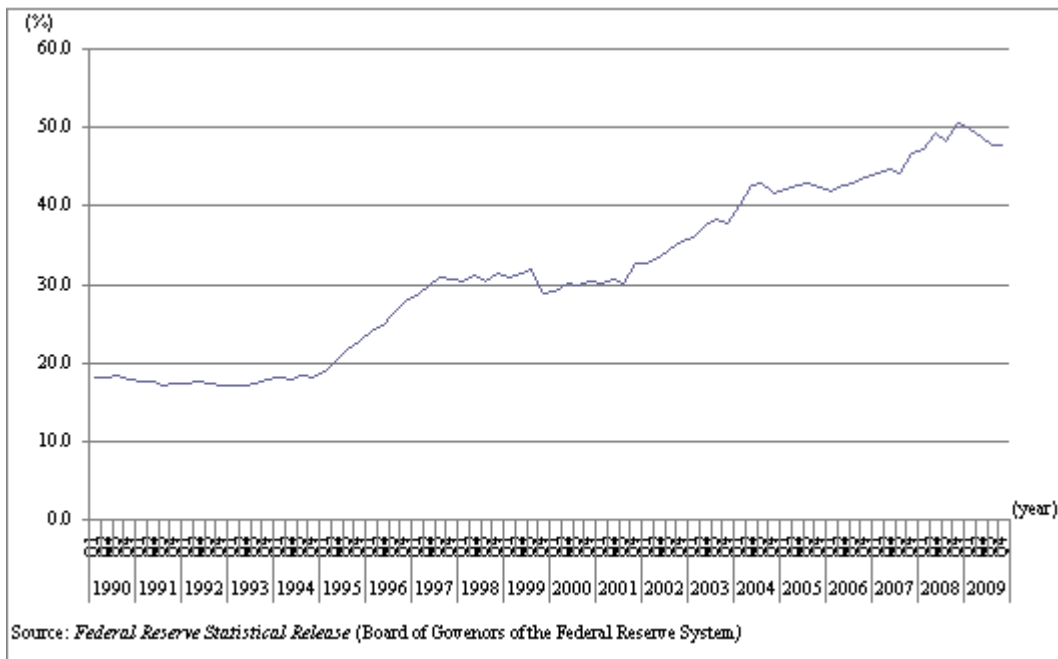
<sup>69</sup> China, Russia and other countries have expressed the possibility of moving forward with diversifying their foreign exchange reserves.

- The ranking official of the People's Bank of China (central bank) expressed the idea that the target for foreign reserves should be diversified into oil and other strategic resources. The financial news report conveyed it as a comment from Sheng Songcheng, the Liao central bank director. The director conveyed the viewpoint that investments to diversify foreign reserves should be done by having a specialized investment firm purchase the reserves from the central bank of China. (Reuters,

**Figure 1-1-2-2: Trends in Foreign Holdings of US Treasury Bonds, and Share by Country (Top 10 Countries<sup>70</sup>)**



**Figure 1-1-2-3: Trend of Foreign Holdings Ratio of US Treasury Bonds**



January 4, 2010 “China should invest foreign reserves in oil and other resources – ranking official of the People’s Bank of China”)

- Central Bank of Russia First Deputy Chairman Ulyukaev made clear on the 29<sup>th</sup> that there was no plan to reduce the ratio of U.S. treasuries held in foreign reserves in addition to the possibility that the Canadian dollar or Australian dollar could be added in the future. (Reuters, September 29, 2009 “Possibility of including the Canadian dollar or Australian dollar in foreign reserves in the future – Central Bank of Russia Deputy Chairman”)

<sup>70</sup> As of February 2010

## **Column 7 Has the global imbalance had a hand in causing the global economic crisis?**

There are various debates on the cause-and-effect relationship between the global current account imbalance and the global economic crisis.

While the IMF has stated that, “there is the possibility that an increasing global imbalance existed on the back of the financial crisis,” they also stated that, “the major causes that brought about the crisis was delayed risk management by large financial organizations and a failures in regulations and oversight of the financial sector.”<sup>71</sup>

Meanwhile, the IMF indicates that, “a consensus is forming between experts in America that presume that the fundamental cause of the financial crisis is the global imbalance.”<sup>72</sup>

Here we will mainly introduce the concerns that, “the financial crisis will occur again if an ever increasing global imbalance is not prevented.”

### **1. Viewpoint that the global imbalance was what caused the global economic crisis**

(1) U.S. Treasury Secretary Henry Paulson (during the Bush administration)

Summary of comments made at a news conference regarding the financial recovery bill (November 12<sup>th</sup>, 2008)

“Specific financial regulations are vital. However, if we do not deal with the problem of the global imbalance which exacerbated the out of control financial markets, we will lose the opportunity to dramatically fix the global financial markets and foundation for economic vitality.”

(2) Council on Foreign Relations<sup>73</sup> Adjunct Senior Fellow for International Economics Steven Dunaway

Council on Foreign Relations Special Report “The Global Imbalance and Financial Markets” (March, 2009)

“In order for the G20 to prevent a crisis such as this from occurring in the future we must consider the global imbalance and international financial system which amplified the crisis. If no countermeasures are taken the imbalance will once again increase due to the recovering global economy and another global crisis will occur mainly because of it.”

(3) FRB Chairman Ben Bernanke

Speech at the Federal Reserve Bank of San Francisco

“In order to achieve a more balanced and sustainable economic growth and reduce the risk of

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<sup>71</sup> IMF (2009), World Economic Outlook, April 2009.

<sup>72</sup> Kouki Takeshita (2009), “The Global Imbalance as the New International Fire” Foreign Affairs.

<sup>73</sup> Council on Foreign Relations. Established in 1921 with the main office in New York. It is a not for profit membership organization. The council analyzes and researches diplomatic problems and international situations while focusing on educating through public surveys. It is a bipartisan organization. It is known for having an international tone. The organization is known for the publication of its diplomatic magazine, ‘Foreign Affairs’. A great number of members are administration officials, from public agencies, congress, international financial organizations, large corporations, colleges and consulting firms. The organization is said to have a remarkable influence on America’s overseas policy decisions.

financial insecurity, we must prevent the expansion of the unsustainable global imbalance. There is the possibility that the global imbalance will once again increase if the global economy recovers and trade amounts returns. As was emphasized by the leaders at the G20, authorities in each country must prevent this from occurring.”

(4) International Monetary Fund (IMF) Former Research Bureau Chief, Harvard University Professor Kenneth Rogoff

Report “The Global Trade Imbalance and Financial Crisis” (November 2009)

The global imbalance did not directly bring about the housing bubble. However, the global imbalance and financial crisis are closely related to the problem.”

(5) Chairman of the Peter G. Peterson Institute for International Economics, Fred Bergsten

Foreign Affairs Magazine 2009 Nov. – Dec. Issue “The Dollar and Fiscal Deficit”

“As long as the United States does not make an effort to escape from this financial crisis, move forward with new policies for the current account deficit, reduce the budget deficit, balance the budget or change to a standard of currency other than the dollar, America and the world will once again face a financial crisis. There is a risk that the financial crisis will reoccur if various countries once again finance the large budget deficits of the United States similar to this financial crisis.”

As was shown above, while there may not be a direct cause-and-effect relationship with the financial crisis, there are many experts in the United States that are sounding the alarm stating that if the global imbalance is not corrected the financial crisis will once again occur.

## **(B) History of the ever expanding global imbalance**

As we have seen, the increasing global imbalance and current account deficit of the United States was made possible by financing from Japan, Germany and the euro zone in the 1990’s and emerging countries such as China and oil-rich countries in the Middle East in the 2000’s (Figure 1-1-2-1). We can confirm the history of the increasing global imbalance by specifically looking at the United States, China and oil producing countries.

### **(a) Appropriation of a huge current account deficit by the United States**

The deficit in the current balance of payments in the United States was continually expanded after the 1980’s<sup>74</sup> and during the 2000’s the current account deficit rose to 6% of nominal GDP (Figure 1-1-2-4).

The domestic current account deficit in the United States is inextricably linked to the imbalance between savings and investment. Looking at the trend in balance between savings

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<sup>74</sup> The current account balance momentarily switched to a surplus by a transfer of income in 1991 during the Gulf War.

and investment by sector (IS Balance) between 1980 and the mid- 1990's excess investment in the government sector (= worsening government revenue and expenditures) was a cause for the increasing current account deficit (Figure 1-1-2-5). During the later half of the 1990's with favorable business conditions due to the IT bubble, the fiscal balance improved but robust capital investment by companies leading to increased excess investment in the corporate sector caused the current budget deficit to increase. Because the IT bubble burst during the 2000's, the corporate sector restrained investment which moved over into excessive savings. Meanwhile the worsening fiscal balance due to the bush tax cuts and countermeasures against terrorism and the excessive investment in the household sector due to the housing bubble (increased debt) was a factor in the increasing current account deficit.

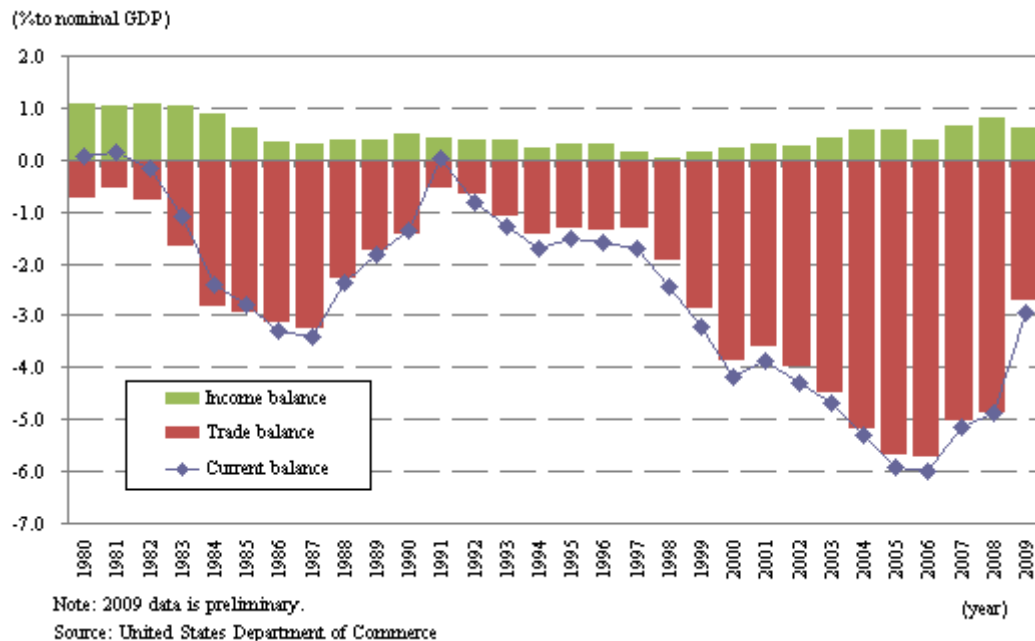
Between 2001 and 2007, the household sector in the United States decreased their rate of savings and increased consumption. As a result of imports continuing to increase from the rise in consumption, the fiscal budget deficit increased significantly between 2002 and 2006 (Figure 1-1-2-5). At the time, the household sector in the United States used funds procured from refinancing their home loans thanks to an increase in housing prices and low interest rates and home equity loans<sup>75</sup> to increase the debt in tandem with the rise in homes further increasing consumption<sup>76</sup>. Furthermore, it is thought that the U.S. economy was financed and demand was stimulated more than necessary by an overabundance of liquidity brought about by the credit easing mainly in developed countries, excessive global savings on the back of rapid growth in emerging countries and development of securitization created by a lower expected rate of return globally which all financed the U.S. economy. The current account deficit in the United States grown to serious proportions by becoming 6% of nominal GDP in 2006 and the flow of funds from abroad which largely exceeded the amount to compensate for the current account deficit continued flowing into the country (Figure 1-1-2-6).

**Figure 1-1-2-4: US Current Account Trend (to Nominal GDP)**

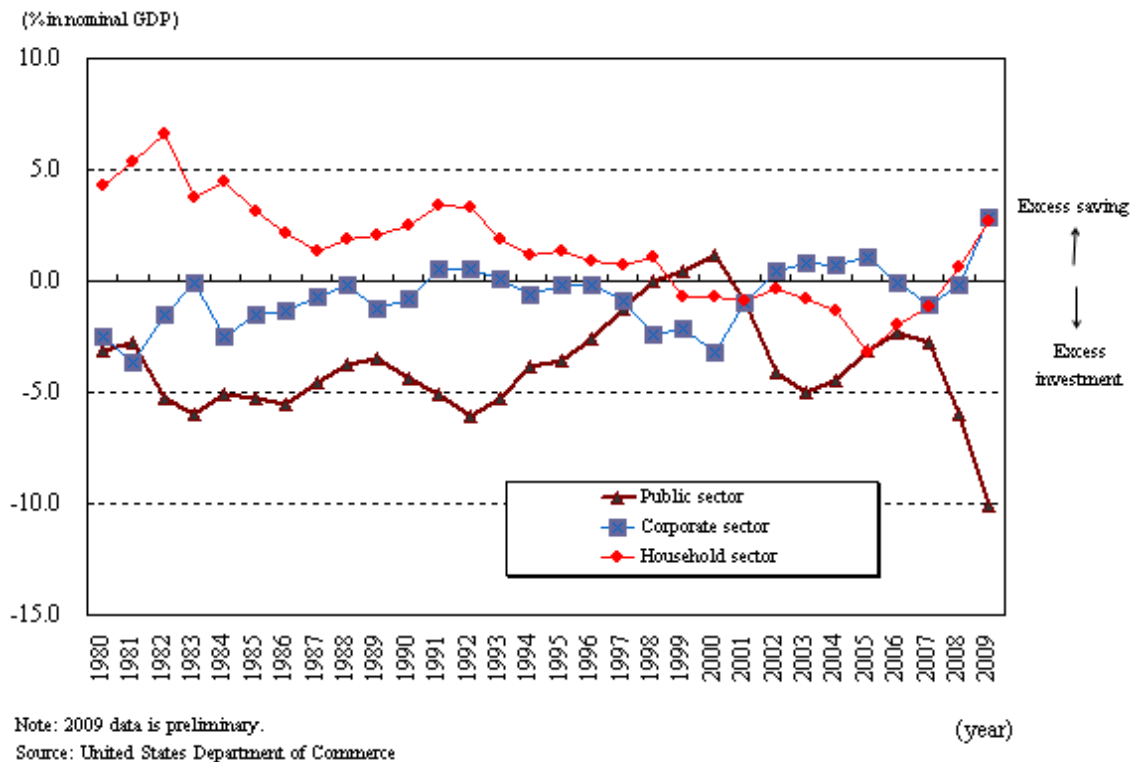
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<sup>75</sup> Loans which use the net value of the homes possessed as collateral and the net value as a line of credit.

<sup>76</sup> Ministry of Economy, Trade and Industry (2009) '2009 White Paper on International Economy and Trade'



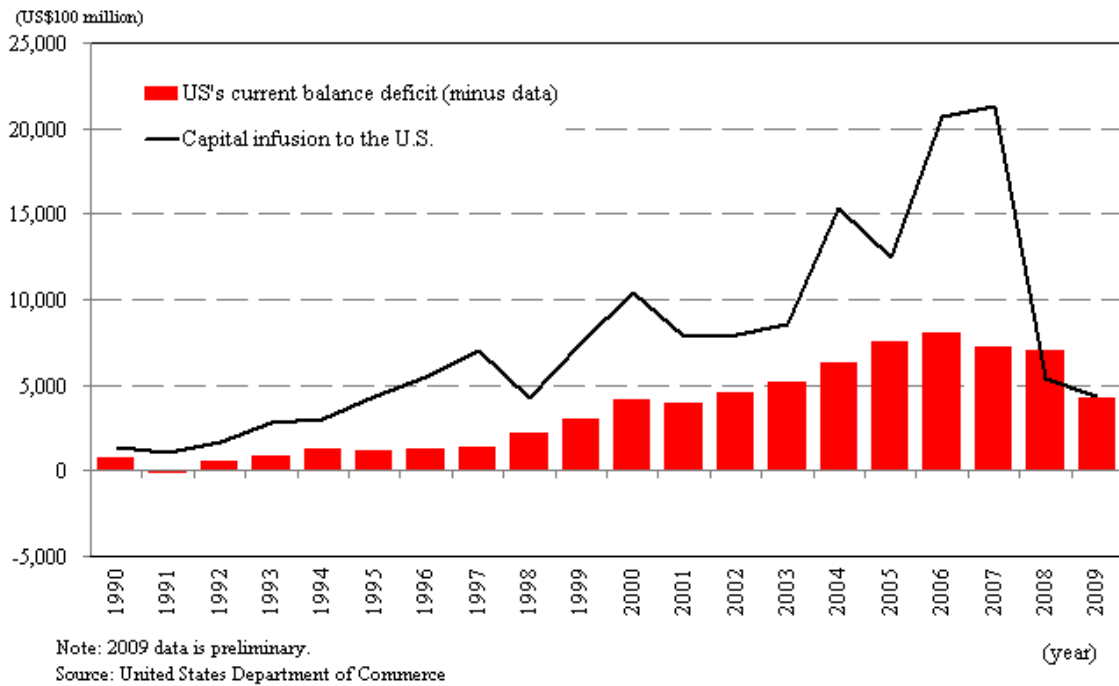
**Figure 1-1-2-5: Trends in US Domestic Savings/Investment Balance**



Looking at the current account in the United States and net overseas assets, even though the current account deficit increased in 2005 net indebtedness to other countries contracted (Figure 1-1-2-7). The decrease in the amount of net overseas assets is theoretically equal in relationship to the amount of the current account for that year. However, as a result of the financial markets

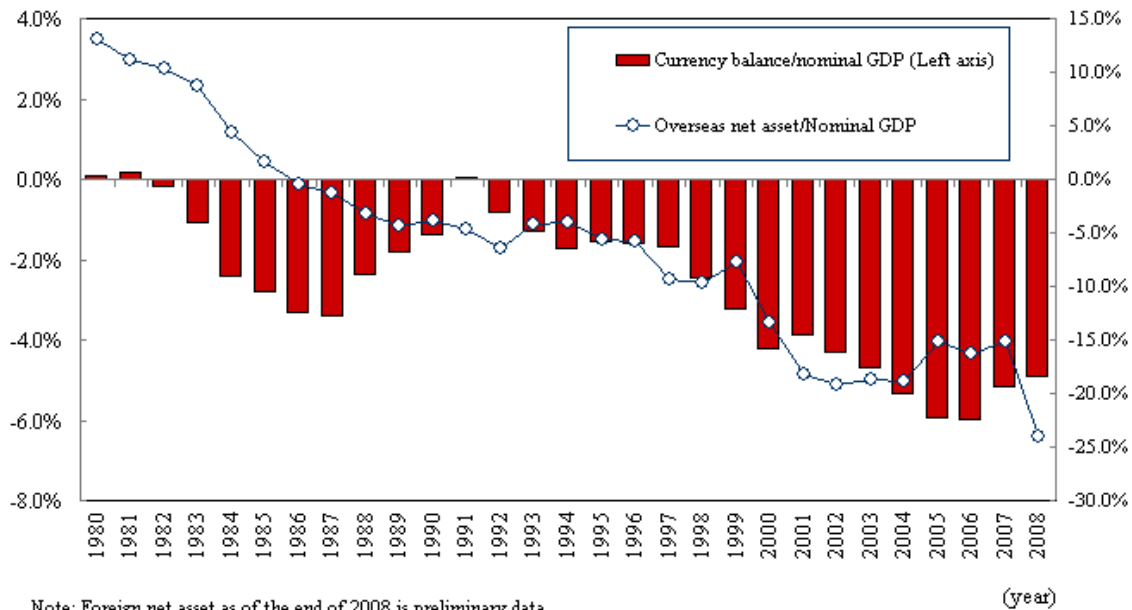
becoming more globally integrated and increased transactions across borders, the capital gain created by the changes in asset prices and fluctuating exchange rates increased to a considerable amount and this restrained the rapid increase in net indebtedness to other countries by the United States<sup>77</sup>. Figure 1-1-2-8 is a comparison of theoretical net foreign claims and actual net foreign claims and you can see that even as the current account deficit increases the effects of the capital gain stabilizes the net foreign claims.

**Figure 1-1-2-6: Trends in US Current Account Deficit and Capital Infusion**



**Figure1-1-2-7: Trends in US Capital Account Balance and Overseas Net Assets**

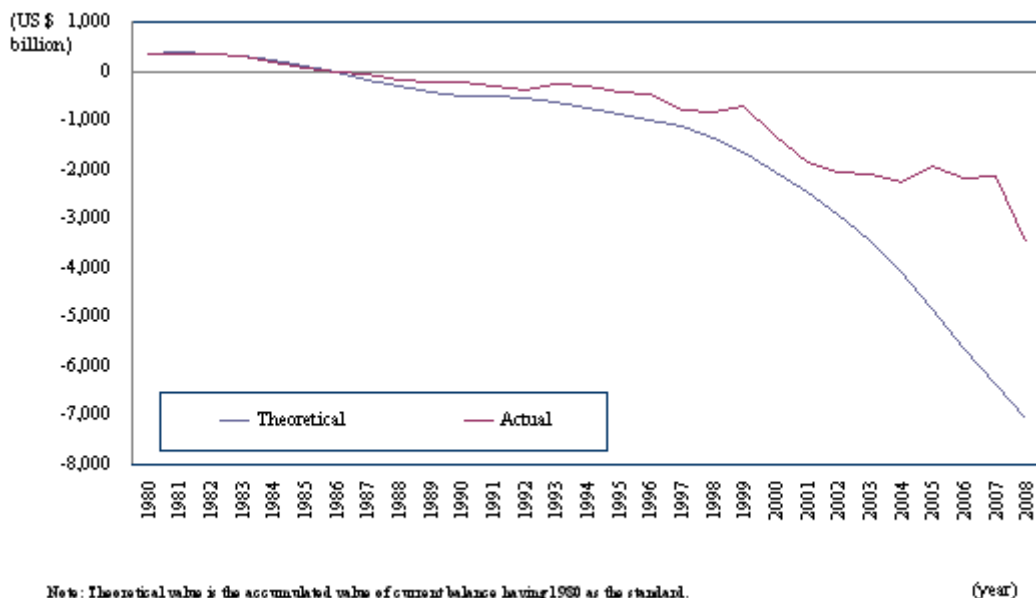
<sup>77</sup> Cited previously, Tanaka (2010), Takekazu Iwamoto (2010), "The Financial Crisis and the Global Imbalance – A focus on the weakness of external highly leveraged positions held in the United States" and others.



Note: Foreign net asset as of the end of 2008 is preliminary data.  
 Source: United States Department of Commerce

Even though the United States is a net debtor nation most of the funds procured from overseas have flowed mainly into bonds with a comparatively low funding cost while funds abroad have went into highly profitable direct investments and stocks which has earned a enormous capital gain<sup>78</sup>, achieving a gain in income (Figure 1-1-2-9)<sup>79</sup>.

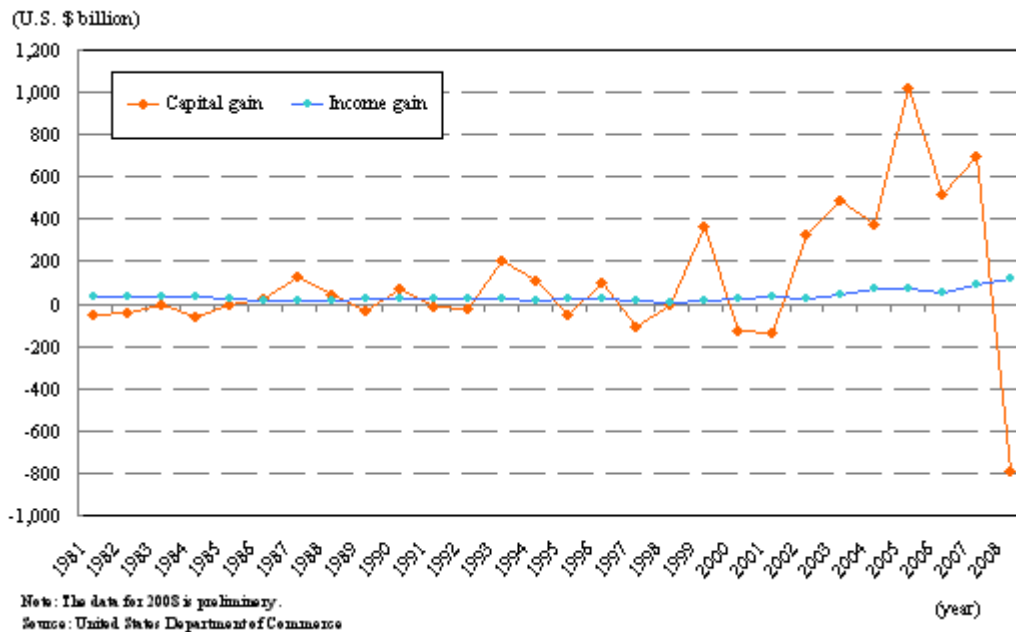
**Figure 1-1-2-8: US Theoretical and Actual Foreign Net Assets**



Note: Theoretical value is the accumulated value of current balance having 1980 as the standard.  
 Source: United States Department of Commerce

<sup>78</sup> Refer to the annotations for the effects of U.S. capital gains on net overseas assets and the current balance of payments.  
<sup>79</sup> According to the Department of Commerce, 57% of net overseas assets (assets overseas held by the United States) held by the United States as of 2007 was made up of direct investments in foreign currencies and stocks. When total net obligations (net assets held by foreign countries in the United States) are examined, direct investments and stocks make up just 30% of the total and government bonds, public assets and other low risk dollar-based assets make up most of the total.

**Figure 1-1-2-9: Trends in US Capital and Income Gains**



**(b) The role of China as the “World’s Factory”**

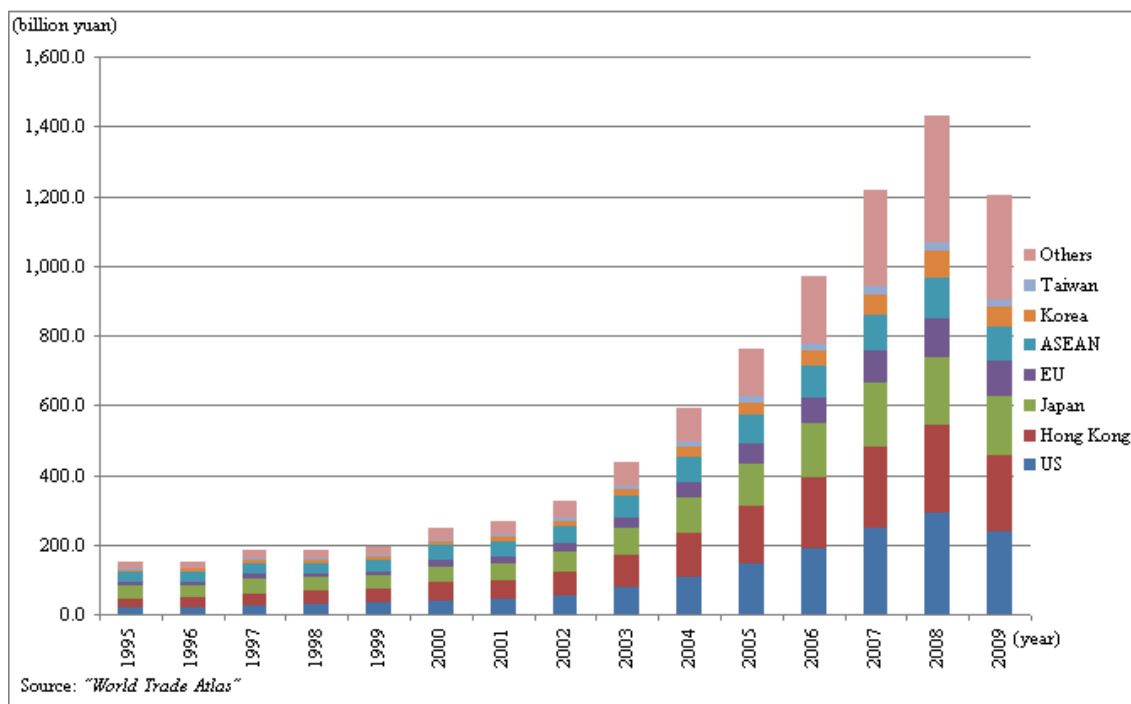
On the back of an enormous inflow of funds from abroad, as opposed to the United States which significantly increased its current account deficit, China has been largely increasing its current account surplus since 2000.

Since the 1990’s, China has started functioning as the base of production for final goods and during the 2000’s, they significantly increased exports mainly of final goods (Figure 1-1-2-10). Countries including Japan have developed their economies through processing trade as the “world’s factory” by importing intermediate goods from abroad, performing the final assembly domestically and exporting most of those goods abroad<sup>80</sup>. As a result, China recorded a substantial current account surplus since 2000 (Figure 1-1-2-11).

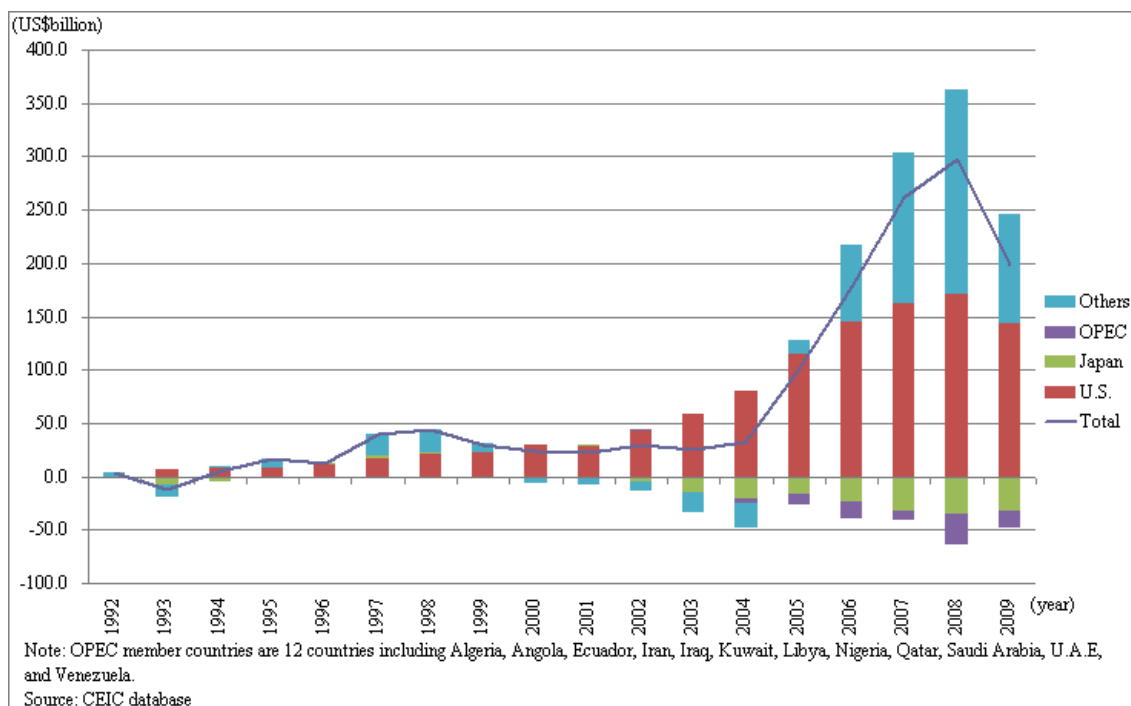
In addition, the importing of mainly raw materials for processing trade as increased along with exports (Figure 1-1-2-12).

**Figure 1-1-2-10: Value of Chinese Exports (Major Trading Nations/Regions, Annual)**

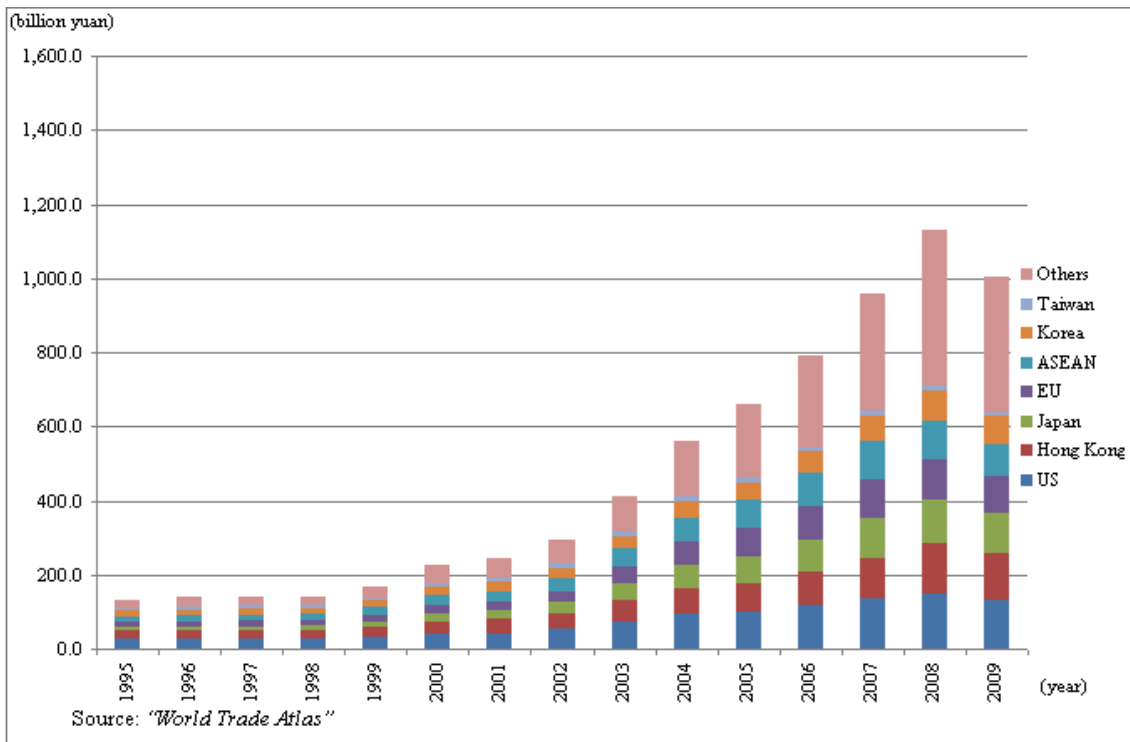
<sup>80</sup> Cited previously, Ministry of Economy, Trade and Industry (2009).



**Figure 1-1-2-11: Expanding Chinese Trade Surplus In Relation to US etc**



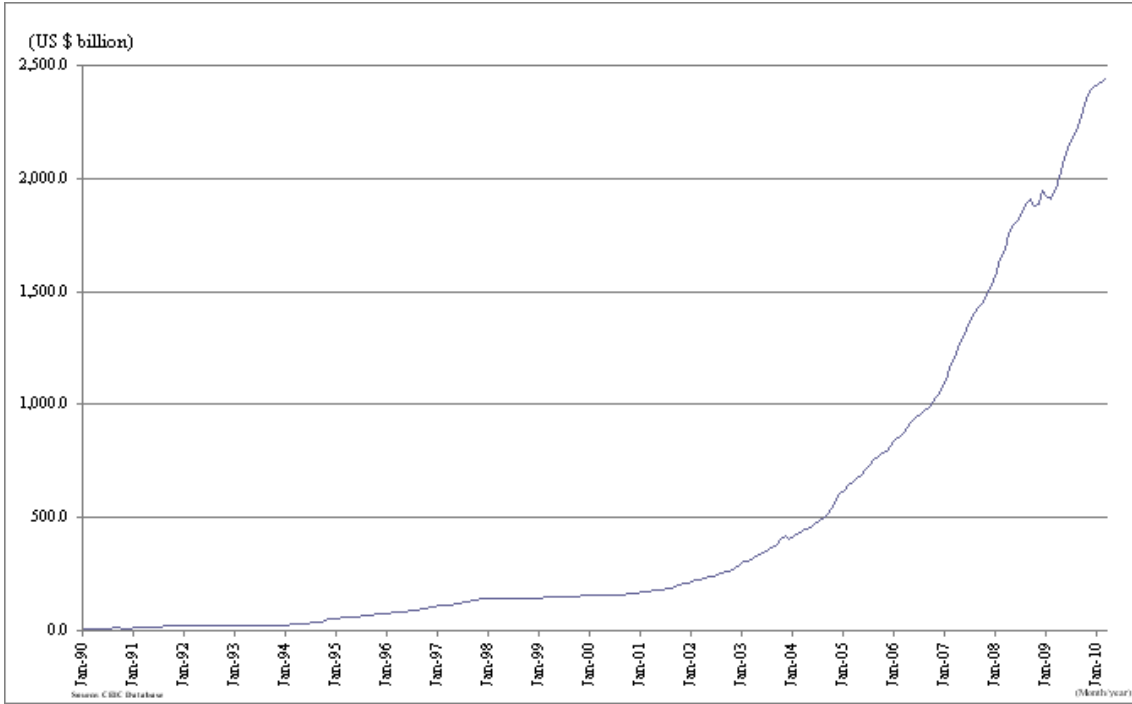
**Figure 1-1-2-12: Value of Chinese Imports (Major Trading Nations/Regions, Annual)**



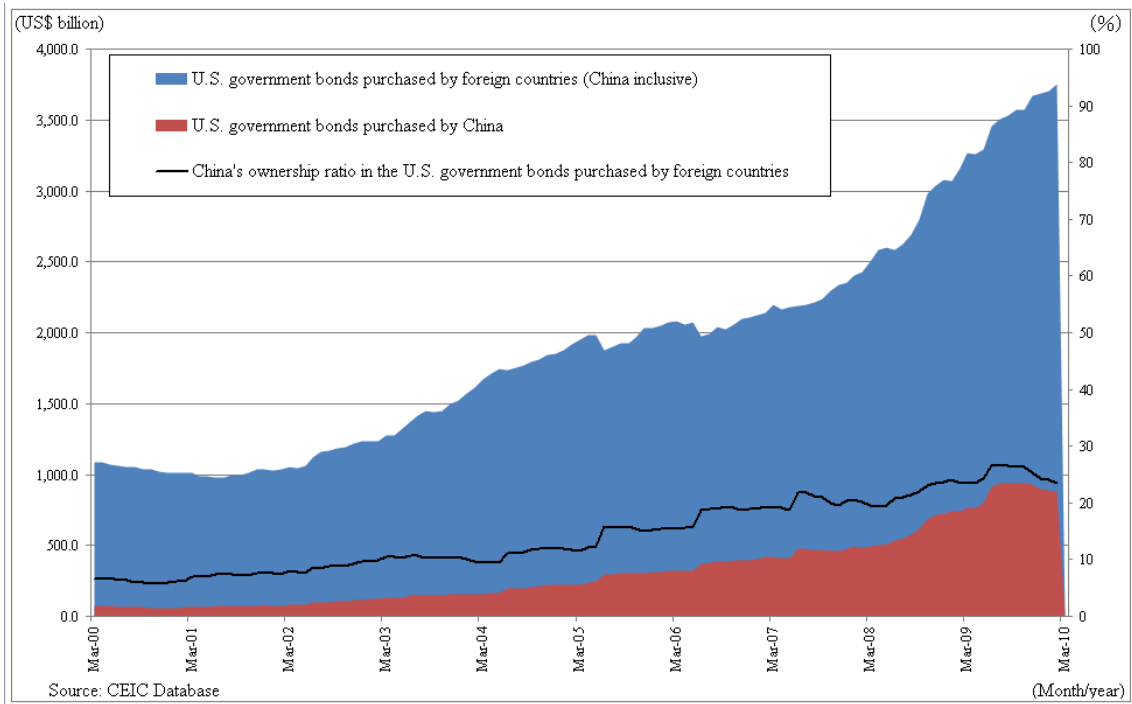
After emerging countries in Asia reflected on the current crisis of 1997, they have been piling up currency reserves on the back of these current account surpluses. China is the country which is significantly increasing their current account surpluses and piling up currency reserves more than any other country (Figure 1-1-2-13).

Most of China's enormous currency reserves head mainly for the United States, which has the largest current account deficit. Of the U.S. government bonds held by investors abroad, China's rate of possession continues to gradually increase and has most recently exceeded 20% of all bonds possessed. China is the world's largest holder of U.S. government bonds (Figure 1-1-2-14, Table 1-1-2-15).

**Figure 1-1-2-13: Chinese Foreign Currency Reserve**



**Figure 1-1-2-14: Trends in US Government Bond Holding Ratio and Value for China**



**Figure 1-1-2-15: US Government Bond Holdings by Foreign Country**

		US \$ 1 billion		Ratio	
		2009/2/1	2010/2/1	2009/2/1	2010/2/1
1	China	744.2	877.5	23.5%	23.4%
2	Japan	661.9	768.5	20.9%	20.5%
3	UK	129	231.7	4.1%	6.2%
4	Oil exporting countries	181.8	218.8	5.8%	5.8%
5	Brazil	130.8	170.8	4.1%	4.6%
6	Hong Kong	76.3	152.4	2.4%	4.1%
7	The Caribbean	189.5	144.5	6.0%	3.9%
8	Taiwan	72.6	121.4	2.3%	3.2%
9	Russia	130.1	120.2	4.1%	3.2%
10	Switzerland	68.2	81.8	2.2%	2.2%
	Others	777.1	862.9	24.6%	23.0%
	Total	3161.5	3750.5	100.0%	100.0%

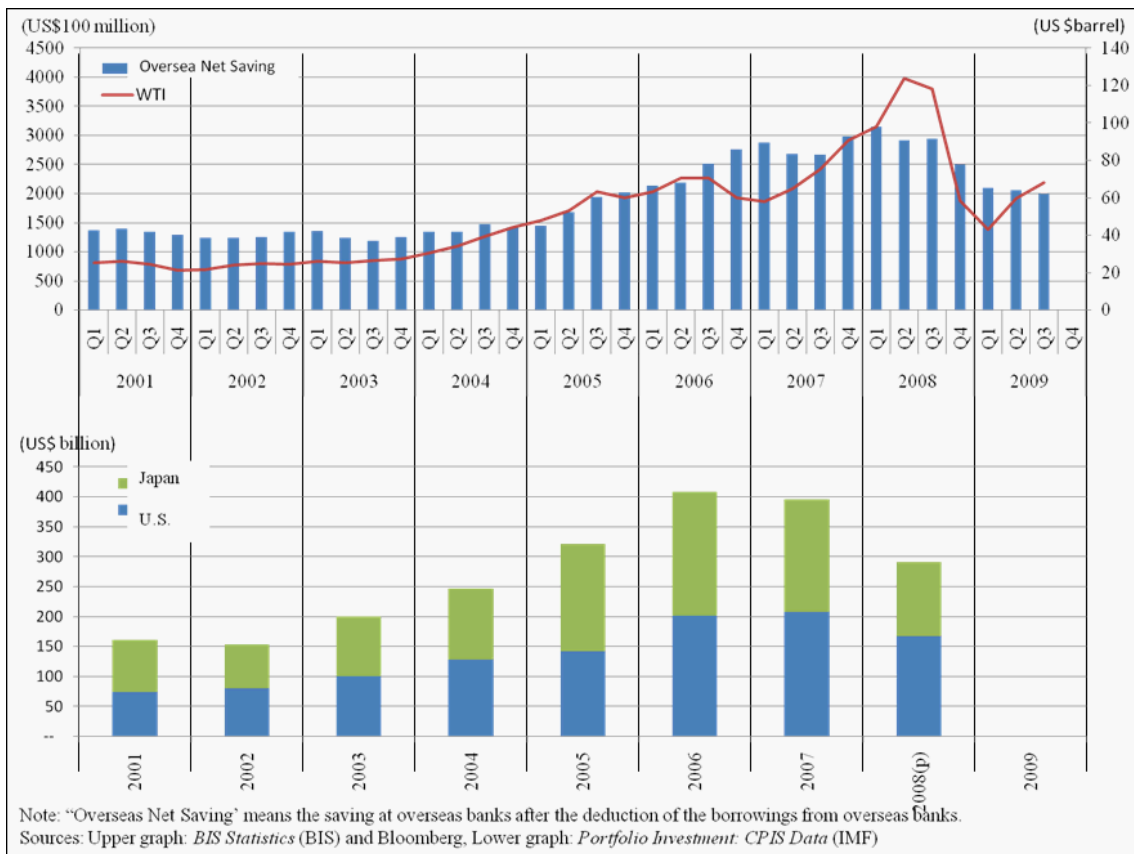
**(c) Oil money from oil-producing countries<sup>81</sup>**

Oil money from oil-producing countries in the Middle East has also financed the current account deficit in the United States. Net external savings of OPEC countries has been increasingly flowing into overseas banks mainly in the United Kingdom and the European Union as the price of oil rises (Figure 1-1-2-16). Overseas banks which accepted the savings have managed the funds by investing in U.S. securities on a large scale. For example, investment in U.S. securities from the United Kingdom has been increasing in step with the rise in savings in OPEC countries (Bottom of figure 1-1-2-16) and it can be seen that a part of the oil money is reflowing into the United States through the United Kingdom and the European Union.

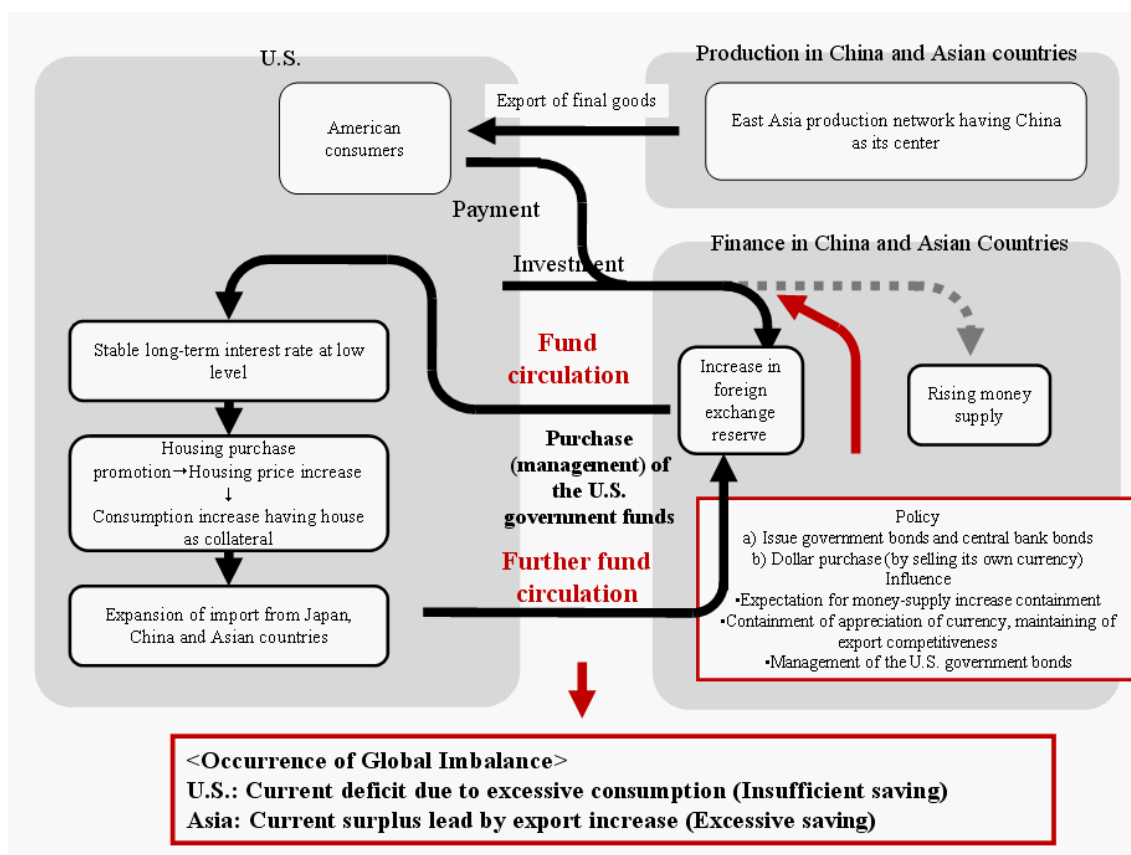
**Figure 1-1-2-16: Top: Trends in Oil Prices and Overseas Net Savings by Foreign Countries as Compared to OPEC**

Bottom: Trends in UK Securities Investments into the US

<sup>81</sup> Ministry of Economy, Trade and Industry (2006) 'White Paper on International Economy and Trade'



**Figure 1-1-2-17: Structure of Global Imbalance Expansion**



Meanwhile, the direct reflow of funds from oil-producing countries can also be seen. For example, a part of the oil money has been allotted to the purchase of U.S. mid- to long-term government bonds and the increase in the holding of mid- to long-term U.S. government bonds by oil-producing countries is trending up. The amount of mid- to long-term U.S. government bonds held by oil-producing countries in the Middle East has increased substantially from 9.8 billion dollars in March 2006 to 21.8 billion dollars as of February 2010. Oil-producing countries are increasing their presence by being the 4<sup>th</sup> largest holder of U.S. government bonds in the world (Figure 1-1-2-15).

The above has been an explanation of the global imbalance which occurred and the situation surrounding it increasing and the following is a summary of above (Figure 1-1-2-17).

### Explanation of Figure 1-1-2-17

- Various countries in Asia ship their intermediate goods to China which processes them into final goods to be consumed and exports them to the United States.
- In China and other countries in Asia, foreign currency received by exporting or inward foreign investment is converted into that country's currency at commercial banks.
- a) In order to prevent inflation, the money supply should be restrained, home currency absorbed and sterilization implemented.

b) In order to prevent the home currency from increasing in value, the government intervenes in the currency markets by buying dollars and the piling currency reserves are put into U.S. Treasuries. In this way the funds reflow to the United States and the historically low long term interest rates in the United States remain stable. Low interest home loans promote the acquirement of homes, the price of homes increases and, as a result, consumption by using the home as collateral increases in the United States.

This causes a global imbalance in the world by creating a situation where the United States has a current account deficit through the rapid increase in consumption (lack of savings) and a current account surplus (excess savings) in Asia driven by exports.

### **(C) Occurrence of the global financial crisis – Rebalancing after the imbalance –**

As we saw in Chapter 1 Section 1-1 the flow of funds in the world largely changed after the global financial crisis and the global imbalance was rapidly adjusted. The following paragraphs take a look at how the current account balances in the United States and China changed after the global economic crisis.

#### **(a) Movement to rebalance in the United States**

The flow of funds into the United States decreased from 2.1294 trillion in 2007 to 534.1 billion in 2008 to 435.2 billion in 2009 (Figure 1-1-2-6). The current account deficit in the United States significantly shrank in 2009 because of this change. When savings and investment by sector in the United States is examined, the financial crisis caused by the collapse of the housing bubble caused a restraint in consumption and increase in savings by the household sector which directly faced adjustments in excessive debt which changed the sector from excessive debt to an excessive savings sector. However, the worsening fiscal budget due to economic policies increased the size of excessive investment by the government sector and this was a factor in the current account deficit (Figure 1-1-2-5).

When the relationship between the current account budget and net external assets after the crisis is examined, even though the current account deficit significantly shrank during 2008, net indebtedness to other countries largely rose (Figure 1-1-2-7).

The United States continued to account for an enormous capital gain until the end of 2007 but this flipped at the end of 2008 into a 795.4 billion dollar capital loss which was a factor in increasing the net indebtedness to other countries (Figure 1-1-2-9).

#### **(b) Movement to rebalance in China**

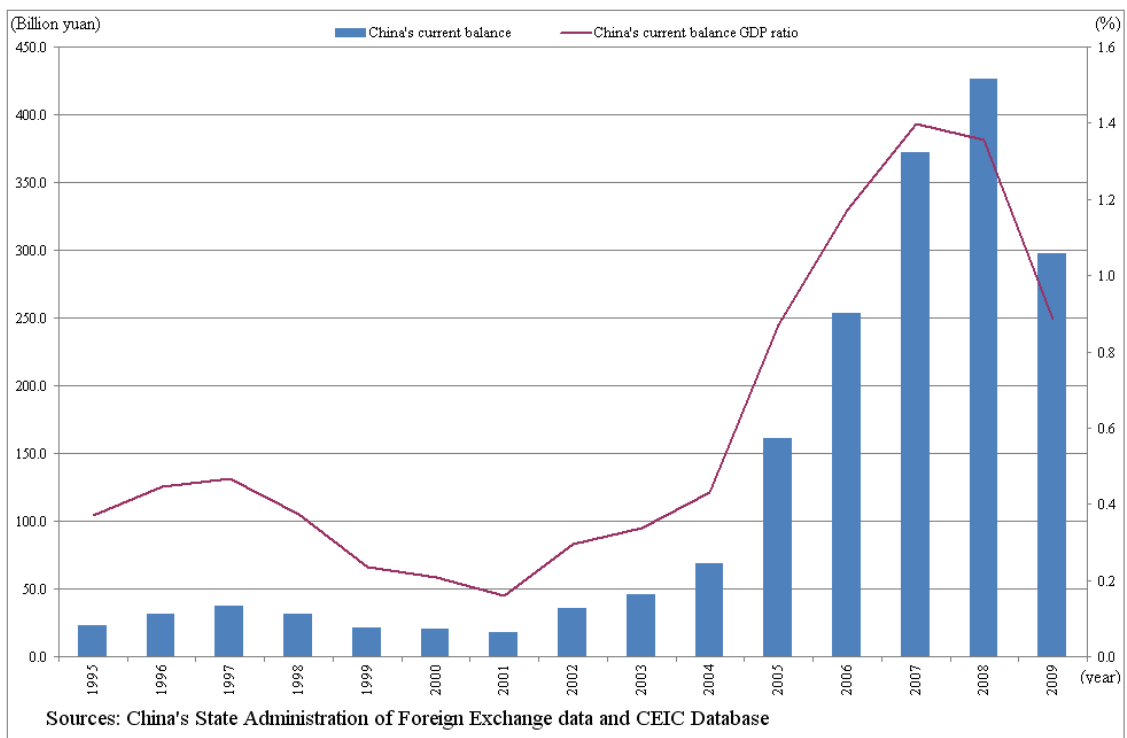
While the current account surplus rapidly increased during the 2000's, with the advent of the global economic crisis, the surplus largely decreased from 426.1 billion yuan in 2008 to 284.1 billion yuan in 2009 (Figure 1-1-2-18).

The trade budget surplus in China also dropped substantially (Previous figure 1-1-2-12).

In addition, exports to the United States dropped in 2009 by 12.5% compared to the previous year to 220.82 billion yuan<sup>82</sup>.

On the other hand, steady consumption in addition to public investment by the government sector has shown strong domestic demand in China after the crisis (Figure 1-1-2-19 and Figure 1-1-2-20). (Refer to Chapter 1 Section 2 “Current state and future forecast for the Chinese Economy”).

**Figure 1-1-2-18: Trends in Chinese Current Account Balance**



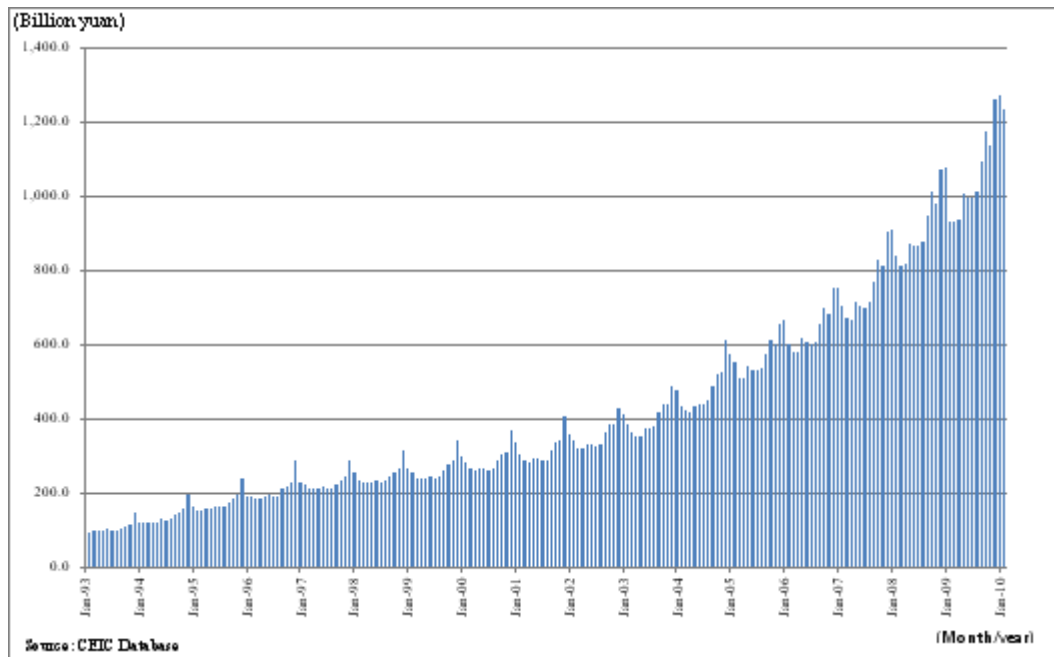
**Figure: 1-1-2-19 Trend of China economic growth rate breakdown**

	Jan-Mar 2009	Jan-Jun 2009	Jan-Sept 2009	2009 (Full year)
Growth rate	6.1	7.1	7.7	8.7
Final consumption	4.3	3.8	4	4.6
Household consumption	n.a	n.a	n.a	n.a
Government consumption	n.a	n.a	n.a	n.a
Capital formation	2.0	6.2	7.3	8
Fixed capital formation	n.a	n.a	n.a	n.a
Inventory increase	n.a	n.a	n.a	n.a
Net export	-0.2	-2.9	-3.6	-3.9

Source: *China Statistical Yearbook* (National Bureau of Statistics of China)

<sup>82</sup> However, the share of exports to the United States out of total exports from China increased from 17.7% in 2008 to 18.4% in 2009.

**Figure 1-1-2-20: Trends in Chinese Retail Sales**



**(c) Preparation for a sustainable correction in the global imbalance**

The global imbalance contracted after the global economic crisis but there are various debates on the sustainability of the rebalancing. (Refer to Column 8 “Will the rebalance be sustained?”)

The IMF<sup>83</sup> states with the size of the current account surplus shrinking that an increase in the real exchange rate, macro economic stimulus packages and structural reforms are all necessary. However, based on the result of positive analysis, while a rise in exchange rates will play a large role in reversing the current account surplus, demand stimulating macro economic stimulus measures or structural reforms are expected to bring the best results. Based on this analysis, we will look at representatives of both the surplus side which is China and the deficit side which is the United States.

While consumer spending in the United States has been propped up by effective policies and spending has continued to pick up since the 3<sup>rd</sup> quarter of 2009, the essence is quite different from the increase in spending which was dependant on huge loans before the crisis (Refer to Chapter 1 Section 2 “1. Current state and future of the U.S. Economy”). In a speech given in Tokyo by President Obama on November 14, 2009, he reconfirmed a new growth model “from consumption to exports,” renouncing a repeat of the conventional growth model centered on consumer spending which would put further strain on consumer in the U.S. hampered by debt and increase the global imbalance. Also at his State of the Union Address on January 27, 2010, he promised to double exports within five years and create 2 million new jobs through the National Export Initiative, increase trade financing to small and mid-sized companies and

<sup>83</sup> Cited previously, IMF (2010b).

reform export management systems for high-tech products. A transition in the United States to promoting exports, increased savings and restrained consumption can be seen.

In China, while domestic demand is steady thanks to the effects of measures to stimulate consumer spending for items such as household electronics and aid for purchasing cars, consumption compared to GDP is still at a low level compared to the United States and Japan<sup>84</sup>. Factors for this that are pointed out is the social security system and underdevelopment of transportation infrastructure for commercial establishments. Due to social security being underdeveloped in China, there is a high amount of anxiety about future income and employment and if consumers have a tendency to avoid risk it is thought that they will restrain expenses and move funds over into savings. In addition, spending habits in rural areas of China is low<sup>85</sup> compared to urban areas one of the causes is thought to be the lack of choices for consumption in rural areas. If both the amount and quality of items and services which can be obtained in rural areas is improved through the development of infrastructure a new consumer market is expected to take hold in the rural areas of China. There is movement seen within China itself to transition away from export and investment dependent economic growth, correct the distortions in the gap between the rich and poor and aim for more balanced economic growth. Based on the ideas of a “harmonious society” and “development with the fundamental interests of all Chinese people as the starting point and having everyone enjoy in the benefits,”<sup>86</sup> various efforts are underway in China including measures to aid rural areas, shrink the income gap and increase demand. In the future, the acceleration of efforts to increase sustainable domestic demands such as the development of social security and infrastructure in China is anticipated (Refer to Chapter 1 Section 2: Chinese Economy: “3. Increasing sustainable domestic demand”).

One of the methods of rebalancing argued the effect of restricting exports by adjusting exchange rates. There are increasing complaints in the United States that the Chinese yuan is too undervalued and that interest rates need to rise. The Chinese yuan has been pegged at 1 dollar = 8.27 to 8.28 yuan ever since its decrease in 1994 but its value has been allowed to float upward in value by 18% since 2005. After the global economic crisis hit in September 2008, the Chinese yuan has been valued at 6.8 yuan per dollar (Figure 1-1-2-21). Because this is advantageous for Chinese exports and is creating an account surplus for China, President Obama at a meeting with Hu Jintao, the current Paramount Leader of China, emphasized the idea that, “a Chinese yuan based on market principals is indispensable in correcting the imbalance in the global economy.” (Refer to Column 9 (Debate over exchange rates).

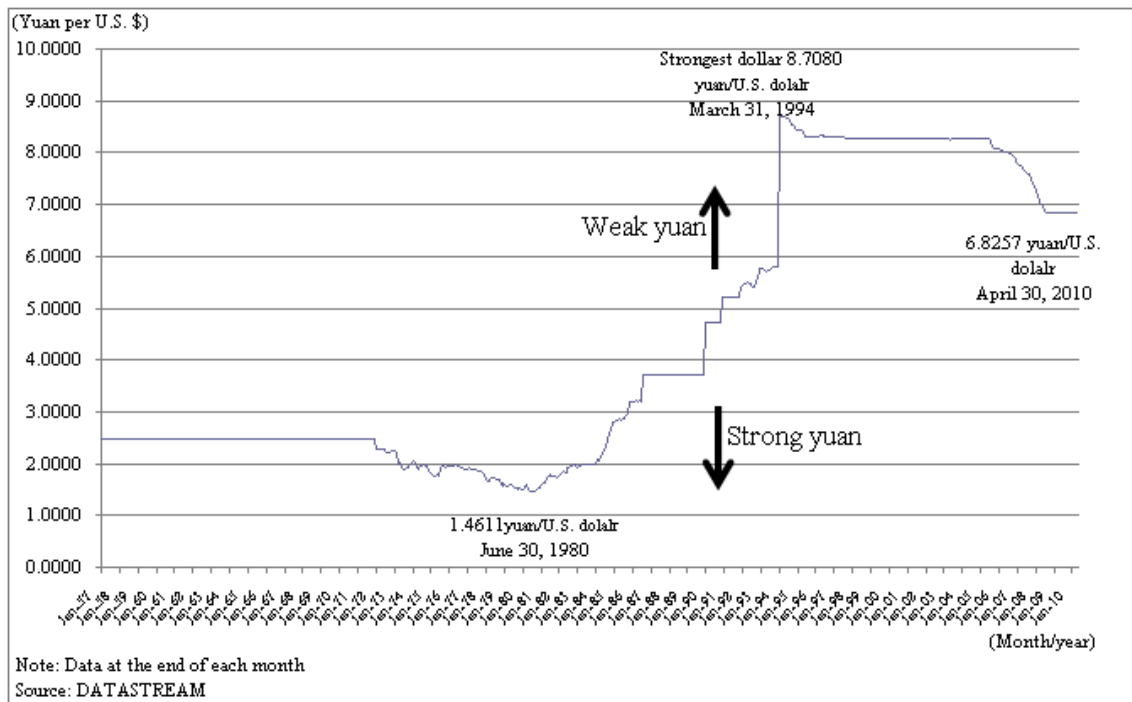
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<sup>84</sup> The 2008 ratio of consumption to GDP was 71.0% in the United States, 57.8% in Japan and 37.3% in China.

<sup>85</sup> The amount of consumption expenditures (made up of disposable income (rural areas are cash based incomes). The higher this is the more aggressive consumer consumption is.

<sup>86</sup> “Party decision regarding a slight problem with establishing a harmonious socialist society” (Adopted during the 6<sup>th</sup> general assembly of the 16<sup>th</sup> Central Committee, October 2006)

**Figure 1-1-2-21: Movements of Chinese Yuan**



**Column 8 Will the rebalance be sustained?**

The global imbalance which rapidly increased during the 2000's has in the short-term been moving towards rebalancing, as stated in the previous section. Factors which are thought to affect the sustainability of the future rebalancing is the business climate in the United States (shrinking of the trade deficit by the resumption of consumption, policies to increase exports and energy-related policies to reduce the import of resources) and the business climate in China (increasing consumption and trends in the Chinese yuan). Trends in the United States are discussed in Chapter 1 Section 2 1. (U.S. Economy), trends in China are discussed in Chapter 1 Section 2 3. (Chinese Economy) and energy-related developments, including the Shell Gas incident which is becoming notice are discussed in more detail in Chapter 3 Section 2.

The following introduces reports discussing the sustainability of the global rebalance.

World Bank Global Economic Prospects 2010

“Whether or not the global imbalance continues to shrink depends on how limited the fiscal and monetary stimulus policies are in the United States and China.”

(Summary)

While the global imbalance is projected to slightly increase once again in the mid term, the sustainability of the rebalance depends on the economic stimulus measures of both the United

States and China. Even if the demodulation of the economic remains stable in the United States while the rate of household savings decreases, if government expenditures are not reduced the trade deficit will once again rise. On the other hand, if China's export competitive strength is increased without expanding domestic demand then the trade surplus will once again increase with the recovery of trade.

IMF World Economic Outlook (April, 2010)

“The global imbalance which is currently shrinking includes some largely temporary elements.”

(Summary)

The current account surplus of China dropped which reflects the stalled manufacturing industry and trade but government expenditures are significantly increasing. During the same period, the current account deficit in the United States decreased after the rise in the household savings rate and sluggish investment. While a lower price of oil was a blessing for both economies, this decreased the large account surplus of economies in the Middle East. However, the factors which are shrinking these imbalances are just temporary and in the future while global trade recovers, cashflows improve and product prices are stable at a high level, the imbalance in current accounts is projected to remarkably increase.

Bretton Woods II Still Defines the International Monetary System (Michael P. Dooley)

“The movement to rebalance will not be sustained due to the further advancement of export-led growth in emerging countries including China, in addition to the resurgence of consumption in the United States.”

(Summary)

If the price of assets recovers to a certain extent in the United States in the future, households will once again decrease savings and continue to increase their debt. Meanwhile, various emerging countries will increase their foreign currency reserves even more than before thank to the global economic crisis. Countries will be increasingly confident that this in addition to export-led economic growth will be the most stable economic strategy in this world of high uncertainty.

The Global Imbalance (Mitsuru Taniuchi, Professor of Waseda University School of Commerce Academy)

“If there is a full-scale recovery and expansion of the U.S. economy and global economy there is a very real possibility that the global imbalance could rise again.”

(Summary)

The United States has lost not industrial vitality in any sectors other than finance. Therefore,

the rate of investment will increase along with the economic recovery and is forecast to return to trending levels (the average from 1990 to 2008 was 19.1% of GDP). Meanwhile, there is a high probability that the U.S. current account deficit will rise when you consider that there is no guaranteeing that the current increase in the rate of savings after 1980 will be maintained or the fact that fiscal deficits could remain high. In addition, the United States has the power to create technical innovation and because there is a high chance that it will achieve a higher rate of growth in the mid term compared to other developed countries, the United States will not lose its attractiveness as a location of investment and it is thought that the flow of funds into the United States will once again grow strong.

On the other hand, let's examine China and oil-producing Middle Eastern countries which have financed the large current account deficit in the United States. As long as there is no fundamental change to the exchange rate policies in China, the country will maintain its significant current account surplus through its continued high level of exports (there are really no indications that there will be any actual changes). The price of oil is forecast to rise in the future with the global economy recovering and the current account surplus in oil-producing countries in the Middle East is projected to rise.

From the above examination, it is believed that the expanding current account surpluses in China and oil-producing countries in the Middle East will be factors which support the global imbalance in the future.

IMF Report "US consumption after the crisis" (Jaewoo Lee, Pau Rabanal and Damiano Sandri)  
"We believe that the current account deficit in the United States will continue to shrink and the slump in U.S. consumption will be maintained."

(Summary)

The trend in ever expanding U.S. consumption which has continued since the 1980's will end and while household assets rapidly decreased after 2008, we see this trend being maintained even after the crisis. Furthermore, we see the continuous slump in U.S. consumption continuing due to the drop in household assets, increasing uncertainty in the macro economic picture and financial system, downward revisions in the long-term economic growth projections and effects of shrinking credit (estimate show a 2.00 to 3.75% drop in demand is projected compared to GDP in the United States).

As stated above, the global imbalance is rebalancing in the near-term, but as shown in the report presented, there are indications of a viewpoint where the global imbalance will once again increase under various circumstances. A watchful eye must be kept on the continuity of the rebalancing in the future.

## **Column 9 Debate over exchange rates**

With many people voicing their opinions requesting a rise in the value of the Chinese yuan, a number of international organizations have issued comments on the implementation of more flexible exchange rates. While these institutions suggest that more flexible exchange rates could play a certain role in correcting the global imbalance, they state that there will not be ample results unless there are also macro economic policies to stimulate domestic demand and structural reforms to correct the imbalance. Moreover, there can also be seen indications for the need to ease concern over the loss of export competitiveness. As countermeasures, these international organizations find that it is necessary to stabilize currencies through policy coordination within Asian regions on exchange rates and the amount of foreign exchange reserves held and by controlling liquidity.

### **(1) International Monetary Fund (IMF)<sup>87</sup>**

“While raising exchange rates has played a certain role from time to time, the most desirable results have come from domestic demand stimulating macro economic policies, or in certain cases, a structural reversal which solves the problems of the root imbalance.”

(Summary)

The IMF made public the World Economic Outlook for April 2010 on April 14, 2010. In the report is the analysis of 28 developed and emerging market countries which transitioned from large and long-term current account surpluses over the last 50 years. According to the report, a rise in real exchange rates would slow down growth but this was counterbalanced structural reforms and other policies including improvement in global demand and terms of trade, macro economic stimulus policies and liberalization of trade. Also, the report argues that while the rise in exchange rates placed a vital role in reversing the trade surplus, the best results can be expected in connection with macro economic measures to stimulate domestic demand and structural reforms.

### **(2) World Bank<sup>88</sup>**

“Further flexibility in exchange rates has increased the attractiveness of the domestic market for producers within China and transitioning the economy from export-oriented to domestic sales oriented which may have a hand in increasing domestic demand. However, it does not appear that this will be achieved unless done in conjunction with structural changes such as reducing

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<sup>87</sup> Cited previously, IMF (2010a).

<sup>88</sup> World Bank (2010), Global Economic Prospects 2010.

household and corporate savings.”

(Summary)

Global Economic Prospects 2010 issued on January 21, 2010, indicates that, “whether or not the global imbalance which is shrinking in the short-term continues to shrink in the future will depend on how the United States and China end their financial and fiscal stimulus policies.” In regards to China the reports states that, “the key to if the current account surplus will once again increase depends on whether or not the government succeeds in increasing domestic demand through economic stimulus measures.” At the moment, “economic stimulus measures are being spend on additional infrastructure development and if this does not promote domestic demand and only increases export competitive strength then there is the possibility that China’s trade surplus will increase again in conjunction with global trade recovering. Countermeasures include, “having even more flexible exchange rates to increase the attractiveness of China’s market for producers within China,” and “transitioning the economy from export-oriented to domestic sales oriented by raising the value of the Chinese yuan which may have a hand in increasing domestic demand.” However, the report points out that, “the tendency for China to have a massive trade surplus will not change just by promoting the increase of domestic imports through flexible exchange rates but in conjunction with structural changes that will reduce household and corporate savings,” and argue, “both an increase in the value of the Chinese yuan and structural reforms are both necessary.”

### **(3) Asian Development Bank (ADB)<sup>89</sup>**

“A more flexible exchange rate in China will contribute greatly in transitioning to a more balanced global economic structure. However, when this occurs it is important that careful controls be put on capital liquidity to deal with the rapid flow of capital into the country.”

(Summary)

In the Asian Development Outlook 2010 made public on April 13, 2010, there is a category entitled, “Exchange rate policies and control of liquidity” which states the following.

- A more flexible exchange rate in China will contribute greatly to transitioning the global economic structure to a more balanced one after the crisis.
- The exchange rate should be adjusted by reflecting economic fundamentals. Policy coordination within Asian regions must also be strengthened regarding exchange rates and foreign reserves. An exchange rate which reflects the fundamentals will absorb any shocks, make possible a more efficient allocation of resources and advance the rebalancing process within the region.
- Policy coordination between regions of Asia on exchange rates will ease concerns about the

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<sup>89</sup> ADB (2010), Asian Development Outlook 2010.

loss of export competitive strength of other countries in the region. Additionally, coordination on foreign exchange reserves will decrease the need to hold excess reserves and increase the flexibility of various countries exchange rates.

- The fluctuation in the flow of funds in the short term is wild from time to time and is a disturbing factor for the exchange markets. Furthermore, the flow of short term funds invites the rapid rise in value of a currency and this causes the loss in export competitive strength. These fears can do nothing but lower the momentum in transitioning to a flexible exchange rate. In contrast to this, it is believed possible to promote the transition to a more flexible exchange rate by stabilizing the currency through the control of liquidity.

Because consumption in the United States has shrunk due to the correction of the global imbalance, the scale of global trade is projected to also shrink. In contrast to this, the Director-General of the World Trade Organization has indicated the viewpoint that, “it is important for domestic demand in emerging countries such as China, India and Brazil to increase a certain amount so that the drop in demand in developed countries is covered.”<sup>90</sup>

#### **Viewpoint of WTO Director-General Lamy: Possibility of shrinking trade due to rebalancing**

(WTO Report (November 18, 2009) “Overview of Development in the International Trading Environment)

-Consumption in developed countries is seen decreasing by 1 trillion dollars annually due the 10 trillion dollar decrease in asset prices as a result of the global economic crisis.

- As a result, the current account deficit in developed countries will shrink. In light of the fact that trade has expanded up until now because of the global imbalance, this suggests the possibility that the rebalance will shrink the amount of trade.

1) As a result of the rebalance, isn't there a problem with the export-driven economic growth strategy?

2) How far can demand be increased in emerging countries such as China, India and Brazil which were relatively less impacted by the crisis? Is it possible for emerging countries to fill the gap created by the shrinking current account deficits in developed countries?

- Under circumstances where the slump in demand in developed countries has affected exports from emerging countries in Asia for the long term, the creation of demand within Asia will be necessary for further growth in Asian countries.

- There are various methods to rebalance in Asian countries.

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<sup>90</sup> WTO (2009), Overview of Development in the International Trading Environment.

- Decrease in preparatory household savings due to the development of social networks
- Efficient transition from savings to investment through revitalization of the domestic financial system
- Acceptance of a more flexible exchange rate system
- International coordination to reduce incentives for various countries to hold large foreign currency reserves to protect themselves from future financial crisis, etc.
  
- Whether or not trade shrinks due to rebalancing depends on the possibility of domestic demand in the markets of emerging countries such as China, India and Brazil compensating for the lost demand in developed countries.

However, while the total amount of demand in Brazil, Russia and India, etc. will equal consumption in the United States, there is a belief that it will be inadequate to erase the decrease in demand due to low growth in Europe and the United States over the next few years.

#### **(d) Framework of cooperation by various countries to correct the global imbalance**

With the presence of emerging countries like China, India and Brazil becoming more prominent in the global economy the proportion of world GDP occupied by the G8 has dropped from 70% in 1990 to 60% currently. Under these circumstances, it has become difficult to think about and discuss management of the world economy without involving the emerging economic countries. In addition, further globalization of the world economy and deepening interdependent relationships among economies has made coordination among developed and developing countries more necessary than ever. The occurrence of the global economic crisis in September 2008 resulted in increased momentum for global policy coordination and it is believed that the G20 has played a vital role in the process.

Correction of the global imbalance is one of the agendas of the G8 and G20 and the need for resolving the current budget imbalance was debated at the L'Aquila Summit in July 2009. After this summit a conference with finance ministers and central bank governors from 20 countries (London) during September 2009 and the G20 Pittsburg Summit was held on September 24<sup>th</sup> and 25<sup>th</sup>. At these conferences policies and mutual evaluation of the effects on the possibility of growth and sustainability were considered and “a framework for strong, sustainable and balanced growth” was adopted. The countries also acknowledged in unison the need to correct the imbalance by stating, “there is a need to transition the source of demand from the government to the private sector, establish a more sustainable and balanced growth pattern by various countries and reduce the imbalances in development.”

At the conference of finance ministers and governors of the central bank from 20 countries (St. Andrews) held in November 2009, the “framework for strong, sustainable and balanced growth”

adopted at the leader assembly in September was launched. In addition, a schedule was indicated for the mutual evaluation process where various countries and regions would submit their framework and predictions on policies by January 2010, receive support through the analysis results conducted by the IMF and World Bank by April of the same year and implement the initial stage of the cooperative mutual evaluation process. Policy options to achieve the goals would then be presented at the leader assembly in Canada in June and create detailed policy recommendations at the leader assembly in South Korea in November.

**<<Recommendations to correct the global imbalance at the G20 and G8 Summit>>**

**G8 Summit (July 8 – 10 2009, L'Aquila)**

**- Statement by leaders:**

In order to have stability long term and continuous growth the current imbalance in the current balance must be smoothly resolved. We recognize the importance of working together to ensure necessary adjustments by following strategies agreed upon by multiple countries which includes the support of strong domestic demand in surplus countries and an increase in the rate of savings for deficit countries through appropriate macro economic policies and structural reforms.

**- Joint statement at the expanded summit with five emerging countries and Egypt\*:**

We will cooperate in striving to support domestic demand and achieve a global recovery that is strong, balanced, comprehensive and sustainable. We will work together to promote and ensure the appropriate adjustments in savings and investment that meets each countries situation.

(\* ) The G8 and Mexico, China, India, Brazil, South Africa and Egypt

**G20 Finance Ministers and Central Bank Governors Meeting (September 4 – 5 2009, London) / Declaration by governors**

We will work to achieve stable and sustainable high growth which requires the orderly rebalancing of global demand, removal of domestic barriers and the promotion of efficient global market functions.

**G20 Summit (September 24 – 25, 2009 Pittsburg)**

**- Declaration by leaders**

We will work together to create a framework which presents policies and methods that creates strong, sustainable and balance global growth. There is a need to transition the source of demand from the government to the private sector, establish a more sustainable and balanced growth pattern by various countries and reduce the imbalances in development.

**- Supplemental document on the declaration by leaders**

We recognize the importance of a methodized process in order to ensure more balanced global economic growth. All countries participating in the G20 agree to deal with the weak parts of their economies.

Participating members in the G20 that have continuous and significant external deficits have pledged to implement policies to support private savings while maintaining free markets, strengthening their export sectors and conducting financial restructuring. Participating members in the G20 with continuous and significant external surpluses have pledged to strengthen the sources of growth domestically.

**Conference of finance ministers and central bank governors from 20 countries (November 6 – 7 2009, St. Andrews)**

**- Declaration by governors**

In order to emphasize our new approach of economic cooperation, we have established a G20 framework for strong, sustainable and balanced growth, adopted a detailed timetable and started a brand new mutual evaluation discussion process to assess whether or not we are collectively achieving the goals and policies agreed upon. We will accept assistance in the form of analysis by the IMF and World Bank regarding our country's evaluations and input from the FSB, OECD, MDBs, ILO, WTO, UNCTAD and other international institutions. We have agreed to the following pact.

- Present our policy framework for our country and region, a plan and projections by the end of January 2010.
- Using assistance gained through analysis by the IMF and World Bank on the collective consistency of our common goals of our country's policies, we will implement the initial stage of the cooperative mutual evaluation process.
- We will put together a summary of policy options in order to achieve our goals and have them considered by the leaders at the Summit in June, 2010.
- We will create more detailed policy recommendations and reconsider our mutual evaluations for the leaders attending the Summit in November 2010.

**G20 Finance Ministers and Central Bank Governors Meeting, April 23, 2010, Washington D.C.)**

**- Declaration by governors**

Our Framework for Strong, Sustainable and Balanced Growth for the global economy is a key mechanism through which we will continue to work together to address the challenges

associated with achieving a durable recovery and our shared objectives. In accordance with our timetable set out in St Andrews, we have conducted, with support from the IMF and World Bank, the initial phase of our cooperative and consultative mutual assessment process for the Framework by sharing our national and regional policy frameworks, programs and projections, assessing their collective consistency with our objectives, and producing a forward-looking assessment of global economic prospects. We further provided guidance to the IMF, and other international organizations, to assist us in assessing collective implications of national policies that could improve our global economic prospects and bring us closer to our shared objectives. For this purpose, we have agreed on principles to direct the development of alternative policy scenarios and have further elaborated the objectives of strong, sustainable and balanced growth as outlined in the Annex to this Communiqué. Drawing on these inputs we will deliver an initial set of policy options for consideration by our Leaders at the June 2010 Summit.

For this purpose, we have agreed on principles to direct the development of alternative policy scenarios and have further elaborated the objectives of strong, sustainable and balanced growth as outlined in the Annex to this Communiqué. Drawing on these inputs we will deliver an initial set of policy options for consideration by our Leaders at the June 2010 Summit.

## **(2) Returning to a sound financial system**

This financial crisis exposed the weaknesses of the U.S. financial system looked upon as the leading financial market.

The IMF analyzes the weaknesses of the global financial system as follows.<sup>91</sup>

- (i) There was a collective failure to appreciate the extent of leverage taken on by a wide range of institutions – banks, monoline insurers, government-sponsored entities, hedge funds – and the associated risks of a disorderly unwinding.
- (ii) Private sector risk management, disclosure, financial sector supervision, and regulation all lagged behind the rapid innovation and shifts in business models, leaving scope for excessive risk-taking, weak underwriting, maturity mismatches and asset price inflation.
- (iii) The transfer of risks off bank balance sheets was overestimated. As risks have materialized, this has placed enormous pressures back on the balance sheets of banks.
- (iv) Notwithstanding unprecedented intervention by major central banks, financial markets remain under considerable strain, now compounded by a more worrisome macroeconomic environment, weakly capitalized institutions, and broad-based deleveraging.

### **(a) Debate at the G20 and future forecast**

In response to the global economic crisis, the strengthening of financial regulations was a

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<sup>91</sup> IMF (2008), Global Financial Stability Report, April 2008.

major theme at the G20 Washington Summit in November 2008 and the G20 London Summit in April 2009. In the declaration by leaders at the G20 Pittsburg Summit held in Pittsburg in the United States in September 2009, (i) reform of reward practices at financial institutions, and (ii) improvements to the quality and amount of bank capital were built into the declaration.

In addition, the progress of a comprehensive reform proposal (\*see next page) for regulations to strengthen capital and liquidity controls by the G20 Finance Ministers and Central Bank Governors Meeting held in Washington D.C. in April, 2010 was also confirmed. This reform proposal was agreed upon at the G20 Pittsburg Summit and has specific details which the Basel Committee on Banking Supervision has considered up until now.

In these ways an international framework of cooperation is exploring methods to prevent the reoccurrence of the financial crisis.

#### **(\*) Comprehensive regulation reform proposal to strengthen controls on capital and liquidity**

Regulation reform proposal to strengthen the current BIS regulations (so-called Basel II) announced by the Basel Committee on Banking Supervision. The proposal is made up of both total equity controls and liquidity controls. During 2010 a final proposal which included the setting of more specific benchmarks and adjustments was formed and the goal is to gradually implement it by the end of 2012 when the financial situation has recovered and the economy is certainly recovering.

With the G20 finance ministers receiving support from the IMF, a peer-review-process will be implemented to assess the effects of each country's policies on the global economy. More specifically this includes the following which expresses the direction of financial regulation reforms.<sup>92</sup>

- Analyze and assess whether the growth patterns in supply, demand, credit and debt in each country is compatible with “strong, sustainable and balance economic growth.”
- Determine the consistency and implications brought about by growth in fiscal and monetary policies and credit, trends in the asset markets and foreign currency exchanges, product and energy prices and the current budget imbalances.
- Periodically report to the G20 and International Monetary Fund Commission concerns regarding global economic trends, major risks and growth patterns and proposals provided at G20 policy adjustments.

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<sup>92</sup> Sayuri Shirai (2009) ‘Global Economic Crisis and the Global Imbalance – Implications or an orderly international economy –’ (Keio Jyuku University).

### **(b) Debate over financial regulation reform in the United States**

Before the subprime loan problem surfaced in the United States, the weaknesses in the financial oversight system had been pointed out. Then in March 2008, a debate over how financial regulations should be in the future began.<sup>93</sup>

After the Lehman Brothers crisis, because President Obama believed a factor in the financial crisis occurring was a failure of financial regulation oversight, he announced on June 17, 2009 a pillar of five financial regulation reform bills (Table 1-1-2-22). These reform proposals will prevent large financial institutions from going bankrupt and a bubble from occurring in advance and has a purpose of strengthening the authority of the Federal Reserve Bank (FRB) and the government in order to protect users of financial services.

**Table 1-1-2-22: Overview of US Financial Regulation Reform**

- Five objectives for the financial regulation renovation

1. Promotion of strong control and management for financial institutions
2. Establishment of comprehensive regulations for the financial market
3. Protection of consumers and investors from financial perversion
4. Facilitation of necessary framework to control financial crisis
5. Improvement of international regulatory standard and international alliances

- Renovation of financial regulatory system

1. Establishment of Financial Services Oversight Council
2. Strengthening of FRB's authority
3. Establishment of National Bank Supervisor
4. Establishment of Office of National Insurance
5. Establishment of Consumer Financial Protection Agency

The financial regulation reform bill was passed by the lower house on December 9, 2009 and by the upper house in May 2010. President Obama announced the imposition of a financial crisis responsibility fee toward large financial institutions on January 14, 2010. In addition, a policy was introduced (financial regulation proposal: Volker Rule) which limits the size of financial institutions and what they can practice. A bill based on this policy was approved by the

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<sup>93</sup> The U.S. Department of the Treasury on March 31, 2008 announced, "a blueprint for a modern financial regulator structure". It is a presentation of U.S. financial regulatory reform and was formulated as an action plan to maintain and improve the international competitiveness of U.S. financial and capital markets.

Senate Banking Committee on March 22, 2010. Future progress on deliberations for this bill will be carefully watched.

Financial regulation up until now in the United States has been largely made up of reforms concerning, 1. legislation to relax regulations dealing with changes in the financial environment and, 2. legislation to strengthen regulations dealing with the financial crisis. The purpose of this reform bill is to promote regulation and oversight of financial institutions and is said to belong to 2. above.

The previous paragraphs have taken a look at the international movements to revise the financial system. Various countries are required to adjust their own interests in the process to transition to a time of economic expansion and escape from the global economic crisis. From now on it will be necessary to quickly establish mechanisms to maintain stability of the entire financial system and not just regulations to maintain a certain conventional financial institution along with both flexible mechanisms that meet the situations of each country and the establishment of an international coordinating structure.

### (3) Issues and response to the international trade structure

After the global economic crisis occurred, it was feared that many countries would turn to protectionism and global trade would shrink. However, when the level of global trade after the crisis is examined, while the drop in trade directly after the crisis surfaced was large compared to the Great Depression of the 1930's, the trend has transitioned into a recovery in the short time span of five months after the crisis began (Figure 1-1-2-23).

The fact that all countries acted in presumed international coordination which didn't result in a strict block economization such as what happened in the 1903's is a large factor. It could be said that the WTO structure functioned as a stopping force.

### **(A) WTO annual report and European Commission report**

The 2009 annual report<sup>94</sup> from the Director-General of the WTO states that between October 2008 and 2009, "there was no serious move to protectionism due to the global economic crisis in all areas of the world."

Meanwhile, according to the report, new measures to distort or limit trade targeting agriculture, steel and metals were introduced in 68 countries and regions. Areas of trade effected by these distortions when estimated and rounded up were 1% of total global trade. This was limited to being a secondary factor in regards to the global credit crunch and decrease in demand. However, the report points out that the new limiting and distorting measures did cause damage

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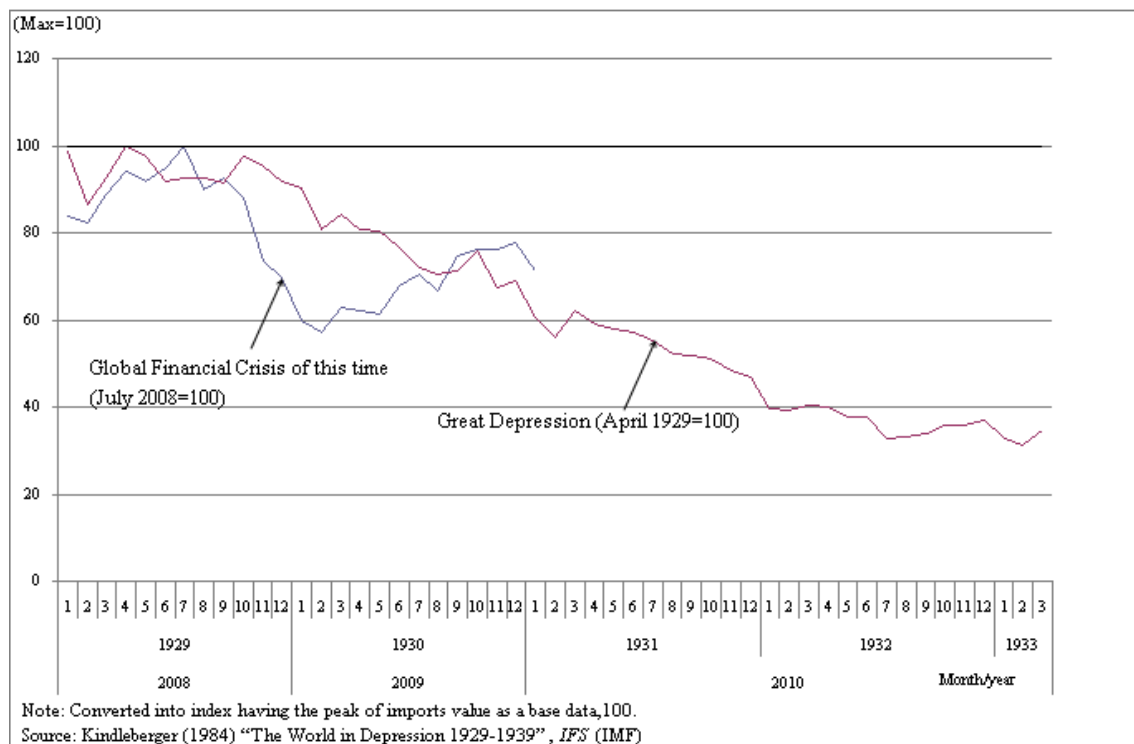
<sup>94</sup> WTO (2009) Overview of Development in the International Trading Environment.

to many bilateral trade relationships, and in some cases caused a remarkable blow to various countries exports and employment picture. It also indicated the idea that, “further enhancement and improvements to the overseeing functions of the WTO were required, based on the experiences of this year, in order to raise transparency in 2010.”

Director-General of the WTO, Lamy stated the following concerning the above-mentioned WTO annual report, “the best method to contribute to the implementation of an exit strategy, respond to shortages in food, energy and natural resources and resolve the environmental problem is -open markets-. Not just the elimination of protectionism but more than that, WTO member countries should promote open markets.”

Strengthening of a multifaceted free trade structure will be indispensable in further promoting free trade in the future. A speedy agreement on the Doha Round negotiations that have continued since 2001 is especially desirable.

**Figure 1-1-2-23: Comparison of World Trade Trends**



**(B) Report by G20 members on trade and investment measures**

In March 2010, the report<sup>95</sup> on trade and investment measures in G20 member countries was jointly put together by the WTO, OECD and UNCTAD (United Nations Trade Development Conference). According to the report, between the last report (September 2009) and the middle of February 2010, there have remarkably been no increase in new restrictive measures to trade or investment in G20 member countries. At the most, 0.7% of imports to G20 member countries

<sup>95</sup> WTO, OECD, UNCTAD (2009), Report on G20 Trade and Investment Measures.

(1.3% the previous year) and 0.4% of total world imports (0.8% previously) which is a decrease from the previous report, and the report states, “an increase in protectionism has continued to be avoided.” (Table 1-1-2-24)

On the other hand, the report points to the fact that between September 2009 and the middle of February 2010, while not against WTO rules, some member countries continue to implement clear measures that restrict trade (raising of import tariffs, introduction of new non-tariff measures, start of anti-dumping inquiries, compensating tariffs, safeguard inquiries, etc.) The reports indicates the fear that there is the continuous high risk that countries turn to protectionism until the economic is on track to recovery and employment opportunities and chances for business begin to look up once again.

**Table 1-1-2-24: The import percentage of the safeguard measure newly introduced by G-20 member nations**

	percentage of world trade	percentage of G20 trade	percentage of trade as object of safeguard
<b>total imports</b>	<b>0.41</b>	<b>0.72</b>	<b>100.0</b>
<b>agriculture</b>	<b>0.02</b>	<b>0.03</b>	<b>4.7</b>
animal (only living) and animal-derived product	0.02	0.03	3.9
plant-derived product	0.00	0.00	0.7
fat and oil	0.00	0.00	0.0
delicatessen	0.00	0.00	0.1
<b>industrial product</b>	<b>0.39</b>	<b>0.69</b>	<b>95.3</b>
mineral	0.19	0.33	45.7
chemical industry product	0.00	0.01	0.7
plastic and gum	0.02	0.03	4.5
leather and fur	0.00	0.00	0.3
wood and wooden product	0.00	0.01	0.9
pulp, paper	0.00	0.00	0.4
fiber for spinning and fiber product	0.02	0.04	5.9
footwear headwear	0.00	0.00	0.0
stone	0.00	0.00	0.7
precious stone	0.00	0.00	0.0
base metal and its product	0.07	0.12	17.0
machinery	0.06	0.10	13.5
transport equipment	0.01	0.03	3.6
accurate equipment	0.01	0.01	1.6
weapon, gun and bombshe	0.00	0.00	0.0
miscellaneous goods	0.00	0.00	0.4
art	0.00	0.00	0.0

Note: period from September 2009 to February

Source: WTO,OECD,UNCTAD:Report on G20 Trade and Investment Mesures(Mar 2009)

The report points to two risks in the future, 1. the accumulation of restrictive trade measures which increases their effects and, 2. financial and fiscal support measures to deal with the crisis are preserved even after the crisis is over. However, the G20 have indicated exit strategies for their trade restriction measures and subsidizing policies and it will be appropriate for these countries to implement the exit strategies once the economic recovery is certain.

### **(C) Response to prevent protectionism from becoming popular in the world**

In response to the issues stated above, leaders from various countries and regions agreed to refrain from newly introducing protective measures for trade at the G20 London Summit held in April, 2009. An international framework of cooperation can be confirmed in the additional declarations made at the G20 Pittsburg Summit (September 2009) and at the APEC Summit (November, 2009) stating the leaders, “refuse all forms of protectionism.”

However, the future is uncertain for whether or not efforts to prevent more protectionism will move forward under international coordination when domestic economic recovery and the employment are the biggest issue in various countries.

Meanwhile, while globalization diversifies economic entities, the decrease in the overwhelming superiority of the United States has created waves in the conventional foundation of cooperation between developed countries with the United States as the center of power. By striving for an open trade structure, external policies will also have effects on domestic policy. With the interests of countries becoming more and more complicated, the enhancement of a multifaceted trade framework based on WTO rules will be indispensable in further promoting free trade. It will be difficult to steer a pressing problem of a high level determination of how each country will adjust to multilateral liberalization and domestic objectives.<sup>96</sup>

(For more information on the effects of the WTO, refer to Chap. 3 Section 2 3. (3) “Efforts by the WTO (response to movement towards protectionism after the crisis and promotion of Doha Round).

#### **(4) Towards a “Multipolar” global economy – Expectation of emerging countries in Asia –**

As we have seen in this chapter, while the global economy is moderately recovering, there are still risks and issues concerning the delay in recovering the function of the financial system and the problem of increasing fiscal deficits. Also, in regards to the global imbalance which is thought to have been created by weakness in the global economy, while the imbalance has contracted during the short-term after the global economic crisis, there are viewpoints that it will once again begin expanding in the mid-term, as pointed out by the IMF.<sup>97</sup> The G20 is moving forward with the development of an international framework to correct the global imbalance and efforts to make the financial markets more sound and coordination by countries with the aim of stable growth in the global economy is anticipated.

Developed and emerging countries are expected to work to achieve economic growth in order for the global economy to attain balanced, robust and sustainable growth. An economy recovery in developed countries is a prerequisite for the total global economy to demodulate.

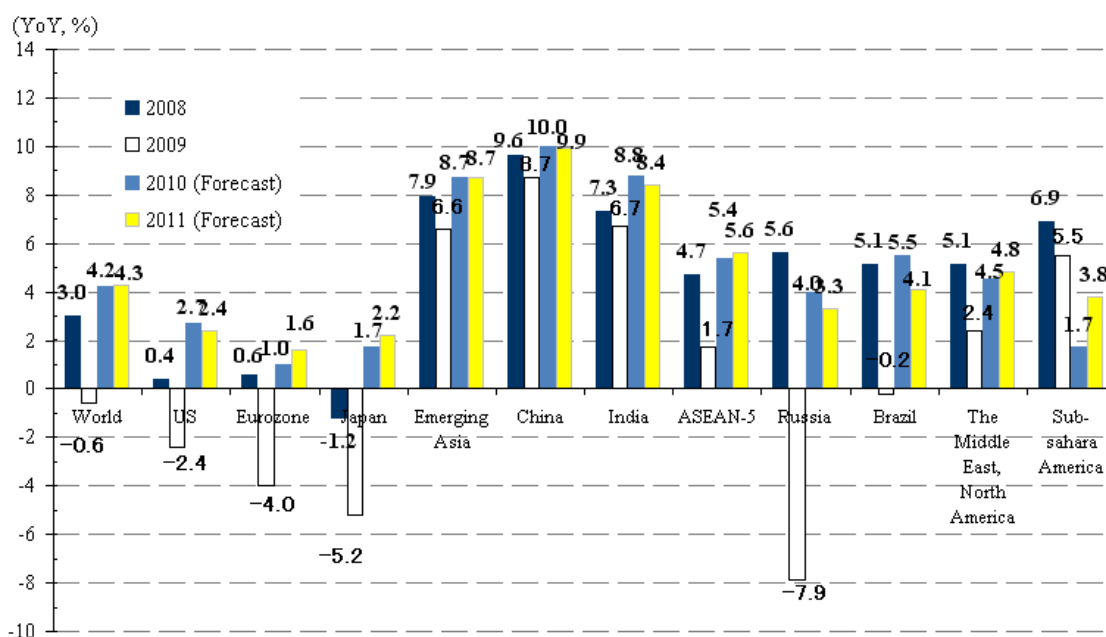
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<sup>96</sup> Yoshiko Kojyo (2009) “Formation and Transformation of the Bretton Woods System” (‘International Problems’ No. 584).

<sup>97</sup> Cited previously, IMF (2010a).

However, according to the IMF, while almost all countries and regions are forecasted to have positive growth in 2010, the recovery in developed countries including Europe and the United States is expected to be comparatively moderate. What will be closely watched is the remarkable growth achieved by emerging countries, including China (Figure 1-1-2-25). As was confirmed in the main body of this document, the economic scale of emerging countries is forecast to accelerate and increase because of the high rate of economic growth. In the past 10 years, the share of world GDP occupied by G8 countries has dropped from 67% to 56%, in contrast to emerging countries within the G20 member countries (G20 members other than the G8) which have increased their share from 24% to 32%, an increase of 1.3 times, and in 2015 this share is forecast to increase to 36% or a 1.6 times increase as of 2009 (Figure 1-1-2-26). The source of global economic growth has spread to a variety of emerging countries and the multipolarization of the global economy is already underway.

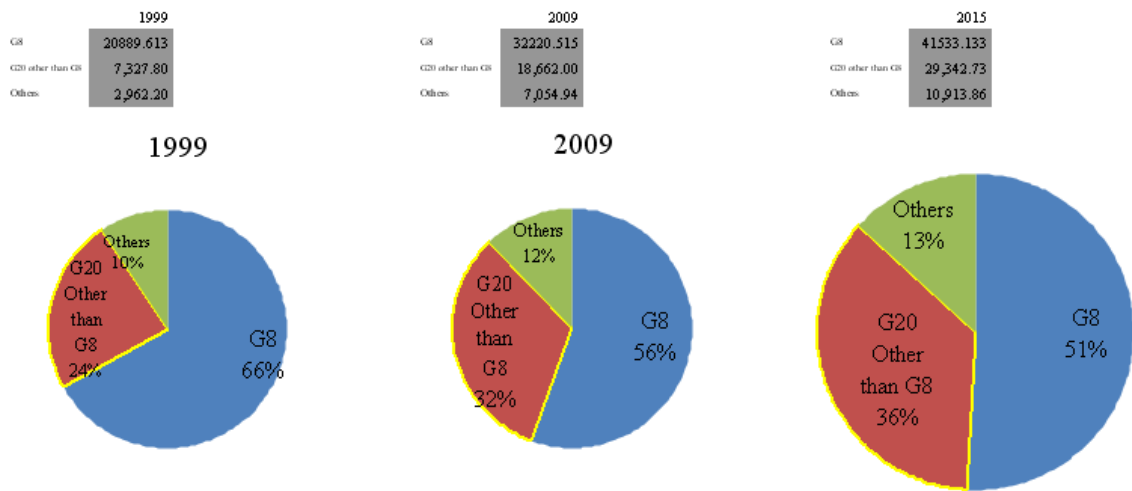
**Figure 1-1-2-25: Outlook for World GDP Growth Rate (Actual)**



Notes: Emerging Asia includes China, India, Indonesia, Malaysia, Thailand, Vietnam, The Philippines and others. ASEAN-5 consists of Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

Source: *World Economic Outlook* (April 21, 2010) (IMF)

**Figure 1-1-2-26: Trends of the scale of economy of G20 (excluding G8)**



Emerging countries in Asia are especially gaining attention from the world. As is described in detail in Chapter 2, during the 2000's the division of labor in Asian regions became more developed and this region established its position as the "world's factory". As the region which was able to recover the fastest from the global economic crisis, there will be expectations for the Asian region as the world's economy on the back of favorable domestic demand. For example, the number of automobiles sold in China during 2009 was 13.62 million cars which exceeded both the United States and Europe to be the most sold in the world (Figure 1-1-2-27). In order for the global economy to have sustainable growth, development of economies in Asian will be more than necessary. Japan is expected to be involved in the development of Asia and achieve economic growth in tandem with Asia.

**Figure1-1-2-27: Trends in Number of Passenger Vehicle Purchases**

