World Economic Trend, Autumn 2005, No.8

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(summary)

Part1 Key Points of Chapter 1

1. Global current account imbalances: expansion of US deficit and expansion of creditor nations

● The current global account imbalance is expanding. The current account of the United States has been an underlying deficit trend since the mid-1970s, and the deficit rose to 6.4% of GDP in the first half of 2005. From 1980 through the early half of the 1990s, the US deficit was much smaller, and most developing countries were in deficit. The current US deficit is financed through the external surpluses of not only developed countries, but also Asian countries and oil-producing countries, which exhibits more imbalance globally than ever(Table1).

Table 1 Current Accounts of the World

(Billions of dollars)

	81-90 average	91-95 average	96-2000 average	2001	2002	2003	2004	2005 (January-June)
United States	-85.9	-73.5	-239.2	-389.5	-475.2	-519.7	-668.1	-394.3
Euro zone	16.5	-12.6	44.8	7.0	48.5	26.7	46.7	-10.0
Germany	26.4	-25.2	-18.7	3.0	45.5	51.1	103.8	61.9
United Kingdom	-12.3	-16.9	-19.5	-31.9	-24.8	-27.4	-42.1	-27.7
Japan	47.6	110.9	103.1	87.8	112.6	136.2	172.1	88.1
China	-0.0	3.4	21.9	17.4	35.4	45.9	68.7	
Asian NIEs	14.3	12.0	33.3	50.6	59.3	84.4	90.2	
Asean4	-6.8	-18.7	10.5	21.7	27.2	30.9	27.6	
Russia	-	2.8	14.1	33.4	30.9	35.4	59.9	
Latin America	-14.1	-37.7	-59.6	-53.2	-15.3	7.0	19.1	
Middle East	6.5	-23.6	15.1	37.5	28.9	57.3	102.8	
Saudi Arabia	-4.3	-15.9	0.3	9.4	11.9	28.1	51.6	
World as a whole	-79.7	-87.1	-92.2	-168.8	-138.1	-75.5	-87.7	
Developed countries	-40.5	8.1	-49.9	-210.8	-222.5	-219.6	-314.0	
Emerging countries/developing countries	-39.2	-95.2	-42.4	42.0	84.4	144.0	226.3	

Source:1. IMF, *World Economic Outlook Database.*
2.Asean4 is Thailand, Malaysia, Philippine and Indonesia.

● While the investment rate in the United States has tended to be flat since the end of the 1990s, the saving rate dropped significantly and excess investment is expanding. Meanwhile, the investment rate has fallen in Germany after the bursting of the IT bubble. The rate has also dropped in a large number of Asian countries after the Asian financial crisis. Those are the factors of excess savings. In China, the saving rate has generally been higher than the investment rate since the 1990s, which is attributable to the high saving rate in the household sector. The saving rate in oil-producing countries has risen, mostly thanks to the rising oil prices.

2. Savings-investment balance: corporate sector shows surplus trend and household sector differs by country

● Comparing the saving and investment balances of countries by sector with those of the first half of the 1990s, the expansion of US current account deficit was driven by the increase in the debt in government sector as well as household sector. In Germany with the deficit of the government sector remaining stable, excess savings of the housing sector are increasing due to anxiety about employment prospects and pensions. In Japan, the household sector has excess saving, the amount of which has been decreasing, and the government sector continues to have deficit. In the United Kingdom, Korea and China, the government sector has relatively been stable.

● Corporate balance sheets substantially improved in a number of countries, excluding China. In United States and Germany, excess investments have decreased after the bursting of the IT bubble, and recently corporate sectors have excess savings. In Japan corporate investments have been restrained since the early 1990s and the corporate sector also has excess saving. In Korea and Thailand, where they were significantly suffered from the Asian financial crisis, investments have been suppressed after the crisis. Meanwhile, excess investment has started to expand again in China since 2002.

3. Trends in corporate balance sheet adjustments of countries following the bursting of the IT bubble

- **Following the bursting of the IT bubble, both the corporate investment and borrowing decreased sharply in the United States. As a result, the balance sheet adjustments ended in a few years, and investment has been picking up since 2003. In several European countries including Germany, where procurement through borrowing continued for a couple of years after the bubble burst, balance sheet adjustments were delayed and investment growth has been weak even after substantial recovery of corporate revenue. In Asian countries, investment decreased after financial crisis in 1997 and began to increase afterwards. However, the investment has been by and large suppressed, if compared to the situation before the crisis.**
- **Focusing on the excess saving of the corporate sector, in the United States capital stock adjustments have ended and it is likely that the excess saving will decrease. In Europe there is a possibility that a situation of excess savings will continue for the time being. In Asia, it is expected that investment will increase accompanying a rise in corporate profits, like China.**
- **Except for the differences in policy responses following the bursting of the IT bubble between countries and the fact that Europe had a huge amount of investment in information/telecommunication technology in 1999 and 2000, there are at least two reasons why corporate balance sheet adjustments have ended relatively faster in the United States. First, firms primarily try to keep their investment within their cash-flow so that they will not have much deficit. Second, even when firms invest more than their cash-flow amounts, they tend to finance their investment mainly through direct financing, where in general they are faced with strong pressure to keep their balance sheets in healthy conditions. Thus, when the IT bubble burst, firms which invested on cash-flow basis were less damaged while those invested more than their cash-flow need to adjust their balance sheets fairly quickly.**
- **Due to factors such as value-added orientation; increased speed of technical innovation; and globalization; the risks that**

companies are faced with are more diversified, requiring corporate management that can respond flexibly.

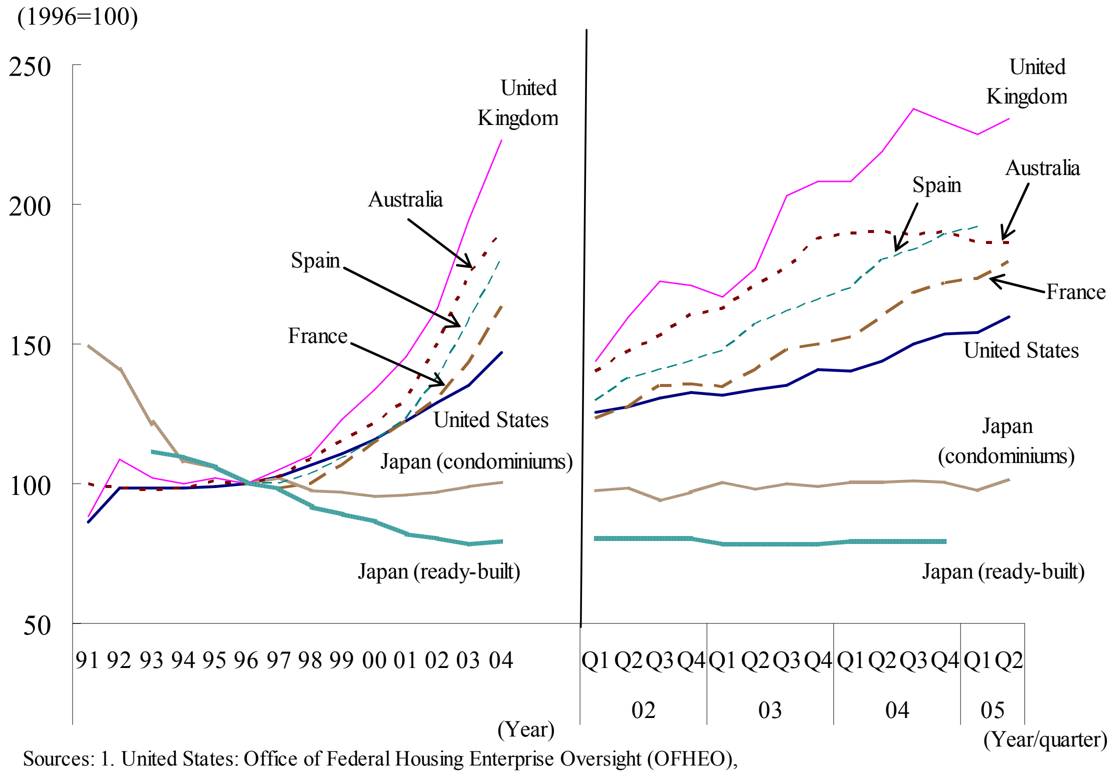
Part1　Key Points of Chapter 2

1. Housing booms have occured in many developed countries due to expansionary policies, such as low interest rate policies

● Since the mid-1990s, housing prices have been rising in several developed countries, e.g. the United States, the United Kingdom and some european countries. The appreciation rate has been accelerated due to low interest rate policies and some other factors following the bust of the IT bubble in 2000.

● While the degree of increase in housing prices differ from one country to another, the house price growth in the United Kingdom and Australia, where the house appreciation rates marked record-high, have declined since 2004, and the housing booms (ie, significant house price appreciation) have mostly come to an end. On the other hand, in Spain, France and United States the house price appreciation rates still remain high, even after 2005 (Figure 2).

Figure 2 Real House Prices



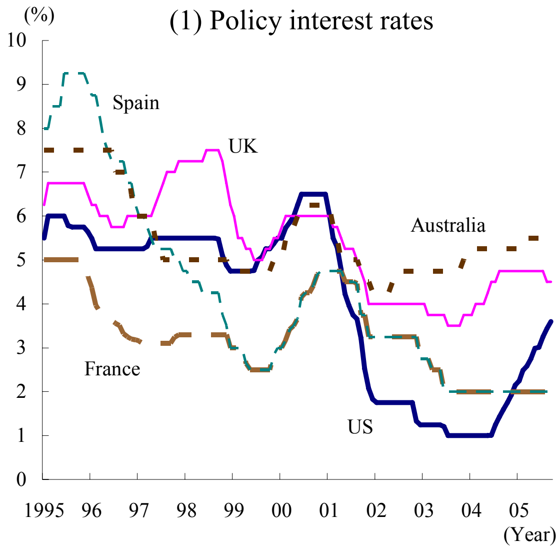
Sources: 1. United States: Office of Federal Housing Enterprise Oversight (OFHEO),
United Kingdom: Office of the Deputy Prime Minister's (ODPM),
France: INSEE,
Japan: Real Estate Economic Institute Co., Ltd., "Trends in the Greater Tokyo Condominium Market";
Real Estate Information Network for East Japan, "Trends in Greater Tokyo Real Estate Market (FY2004)",
Australia: Bureau of Statistics,
Spain: Ministerio de Vivienda, PCE: OECD Economic Outlook 77.
2. Japan uses data for the Tokyo metropolitan area.
3. Real house prices are deflated using the private consumption deflator(PCE).

● Regarding the relationship between housing prices and the economic fundamentals, three indicators which are often used to assess the state of house prices (1) real house prices, (2) ratio of house prices to rent, and (3) ratio of house prices to disposable income. Assessing the US house prices in terms of these indicators, even after the beginning of 2005 they have not exhibited extraordinary high levels compared with those in other countries.

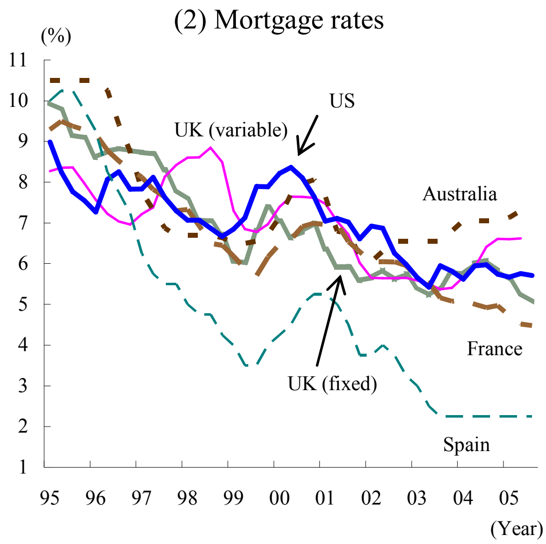
● Several factors that have brought about housing price hike to be considered: (1) low interest rates worldwide, (2) a decline in transaction costs in mortgage (housing loan) markets that developed due to the deregulation of financial markets, and (3) an in home owner-occupation rates due to the development of

the mortgage market and housing acquisition promotion policies, as well as (4) demographic factors, and (5) supply constraints due to strict land regulations (Figure 3).

Figure 3 Trends in Countries' Policy Interest Rates and Mortgage Rates



Source: US: Federal Reserve Bank (FRB), UK: Bank of England, Australia: Reserve Bank of Australia, France: Banque de France, Spain: Banco de España.



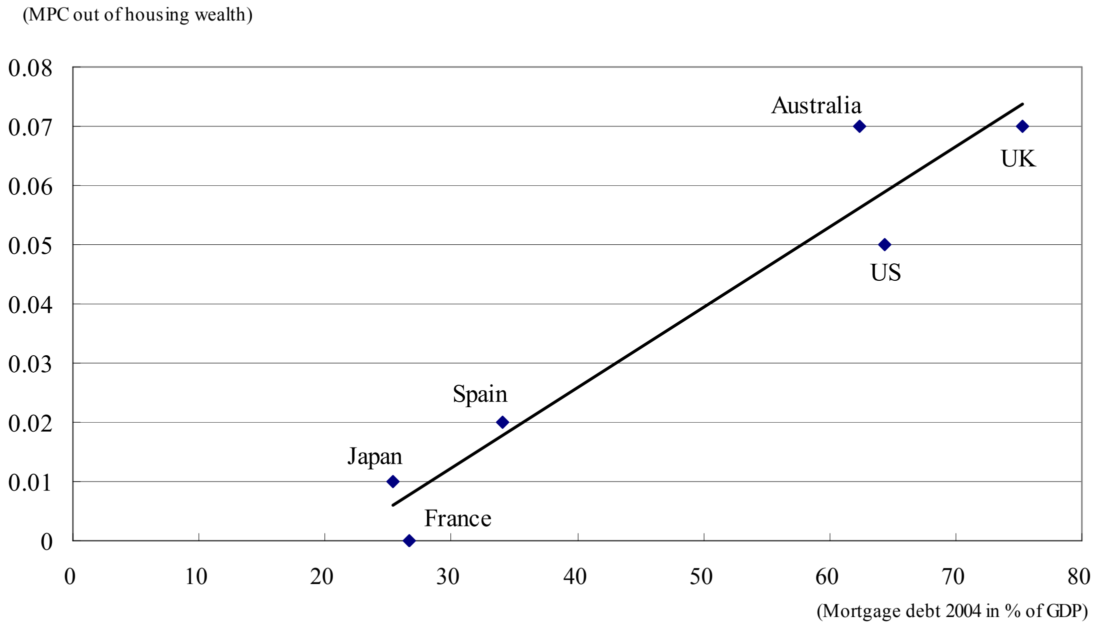
Source: US: Mortgage Bankers Association (MBA), UK: Bank of England for fixed interest rate and Office for National Statistics for variable interest rate, Australia: Reserve Bank of Australia, France: Banque de France, Spain: Banco de España.

2. The consumption expanded through the housing wealth effects in the United States and the United Kingdom

● The rise in housing prices has had the effect of not only expanding housing investment and consumption through the asset effect, but in th e United States and the United Kingdom in particular it has played the role of propping up the economy following the bursting of the IT bubble.

● The size of the housing wealth effect caused by the rise in house prices vary among coutries, and it has been large in the United States and the United Kingdom. In both countries, various mortgage products have been offered, as well as the fact that it is possible for households to easily access collateralized loans gains their house (Figure 4, Figure 5).

Figure 4 Marginal Propensity to Consume out of Housing Wealth and Mortgage Debt



Source: 1. OECD, *Economic Outlook 75*, statistics of countries.
2. Figures for the marginal propensity to consume are OECD statistics based on 1970-2002 data.

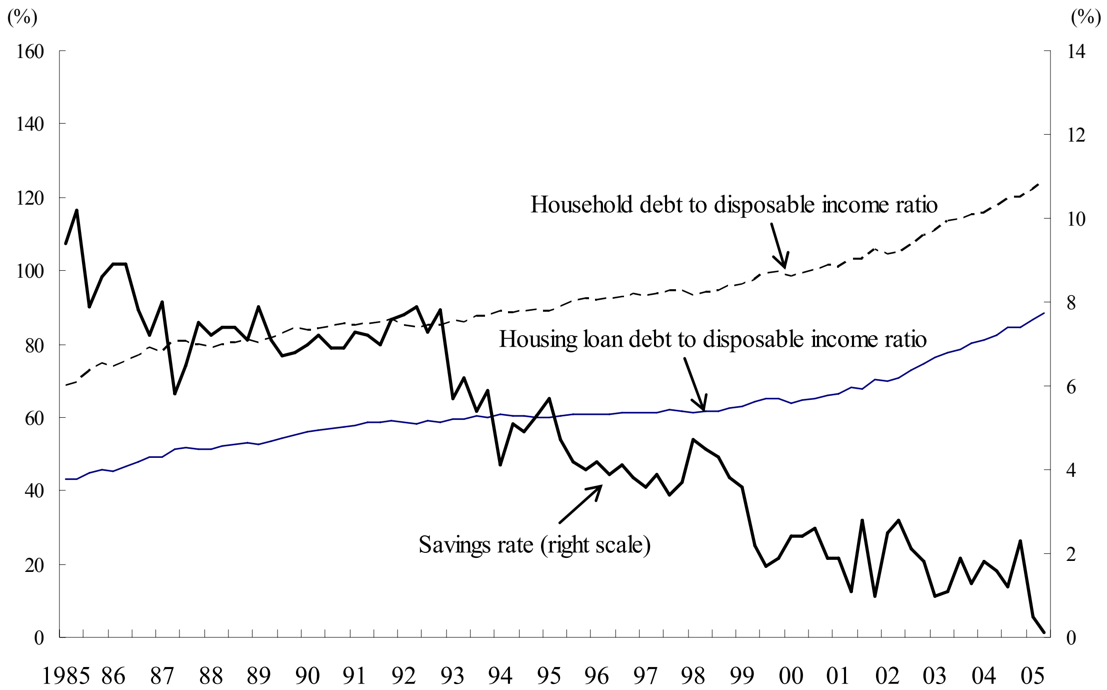
Table 5 Mortgage Market Completeness Index and Other Related Indices

Country	Market completeness index	Reference					
		LTV (%)	Availability of second mortgages	MEW	Share of owner-occupied housing (%)		
					1980	1990	2004
UK	86	69	P	P	58.0	65.0	70.0
Australia	—	65	P	P	71.0	72.0	70.0
US	—	80	P	P	65.0	64.0	69.0
Spain	66	70	P	L	73.0	78.0	*85.0
France	72	67	L	×	47.0	54.0	56.0
Italy	57	55	P	P	59.0	68.0	80.0
Germany	58	67	P	L	—	38.7	42.0
Japan	—	80	P	×	60.0	61.0	60.0

Sources: 1. OECD, *Economic Outlook 75;* FRB, *International Finance Discussion Paper No.841*.
2. MEW indicates whether or not mortgage borrowing for housing would enable homeowners to spend other than for housing investments.
P: Possible, L: Limited, ×: Impossible
3. The * next to the figure for Spain indicates that it is the ratio in 2002.
4. Loan-to-Value (LTV) is a percentage calculated by dividing the amount borrowed by the prices or appraised value of the home to be purchased.

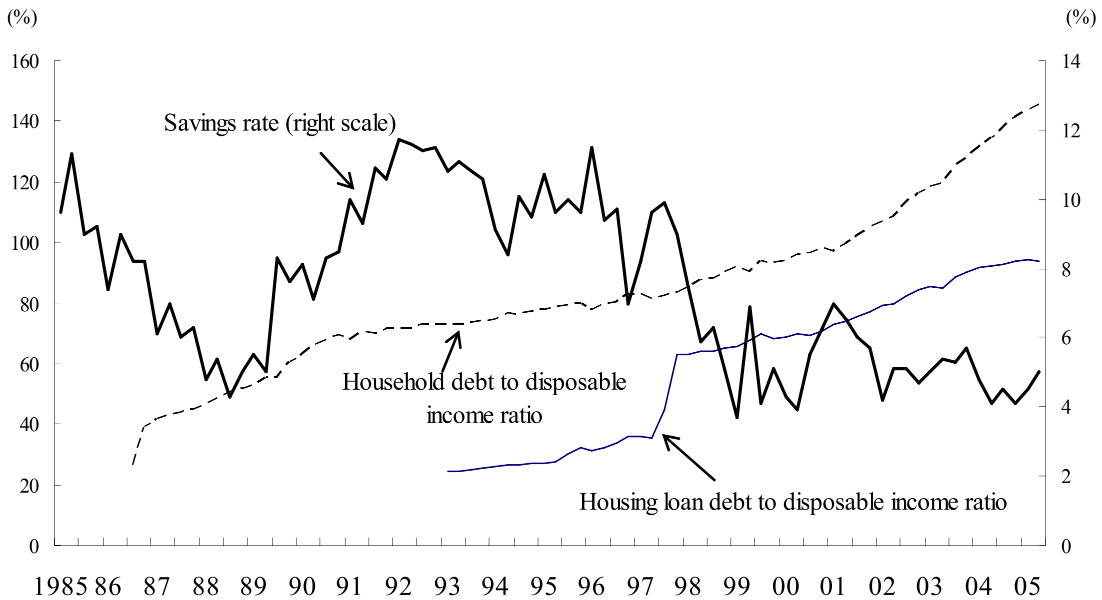
● **Household mortgage debts have accumulated in both countries during the recent upward trend in housing prices. In** the United Kingdom, much of the borrowing increment did not go directly toward consumption. Rather, it was used for the acquisition of financial assets, thus, so far, it appears that the housing boom is coming to an end without hard landing. Meanwhile, in the United States, the speed of the housing price appreciation has been relatively moderate. Nevertheless, under the negative savings rate since the beginning of 2005, it is likely that the wealth effects on cosumption in the United States is stronger than those in the United Kingdom, and that the same magnitude of changes in housing prices would have much larger effects in the United States than those in the United Kingdom (Figure 6, Figure 7).

Figure 6 US Household Debt/Disposable Income and Savings Rate



Source: FRB and U.S. Department of Commerce.

Figure 7 UK Household Debt/Disposable Income and Savings Rate



Source: Bank of England and Office for National Statistics.

3. In times of low inflation the relationship between changes in asset prices and financial policies becomes more complicated

● Behind the relatively rapid recovery of the U.S. economy following the bust of the IT bubble, there were housing wealth effects under significant easing monetary policy, as well as historically large tax cuts. There is one augment that the resilience (flexibility) of an economy should be greatly enhanced by improving the efficiency of monetary policy, which would be materialized by developing mortgage markets just like in the United States or in the United Kingdom and would strengthen the housing wealth effects. This issue has been discussed at international organizations.

● The movements of the housing asset prices and those of CPI do not necessarily synchronize. In particular, under the recent low inflation phenomenon, the discrepancies between them increase further. Therefore in recent years, lively discussions have been taken place in Europe and the United States regarding the at present monetary policy stance in dealing with asset price fluctuations, because central lanks' primary objective is generally price stability.

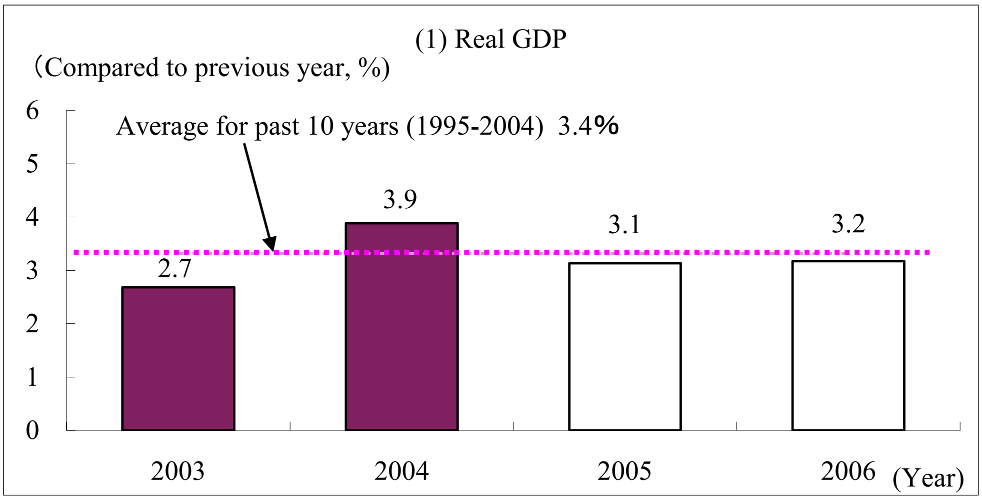
● At present, there is no such a central bank that takes asset prices the primary objective of its policy. Nevertheless, large fluctuations in asset prices have a significant bad effect on the economy and which can not be neglected by policy makers. There is also an aspect in which economic fluctuations are amplified via volatile reactions of the housing prices to changes policy interest rates, making monetary policy operation much more difficult than before.

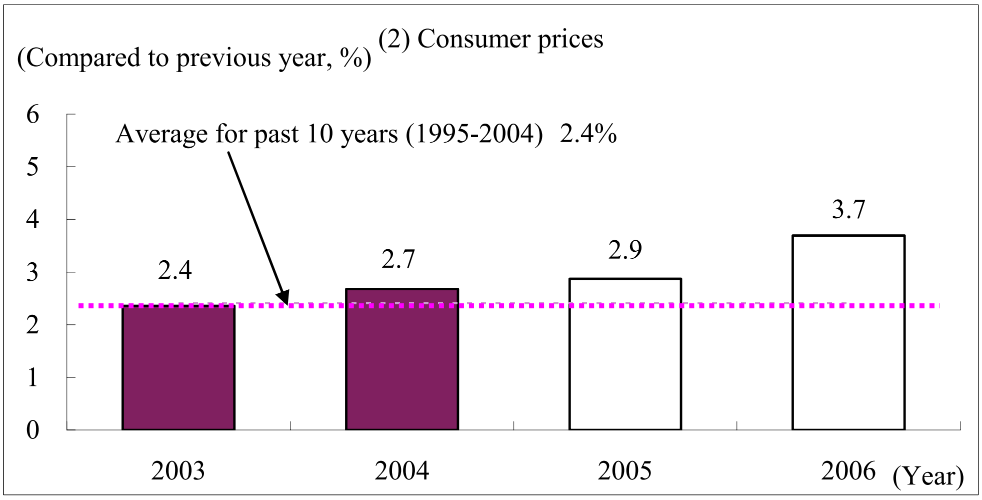
Part2 Key Points of Chapter1

World economy in 2006 expected to maintain growth on par with that in 2005

● The world economy is recovering steadily. While growth in the middle of 2004 temporarily slowed against a backdrop of rising crude oil prices, it picked up in January-March 2005. In 2005 the growth rate of the world economy as a whole (22 countries and regions with deep ties to Japan) declined moderately from 2004's rate to about 3.1%, and it is expected that in 2006 growth will be about 3.2%, remaining at a comparable level to that in 2005 (Figure 8, Figure 9, Appendix).

Figure 8 Forecast for the World Economy (22 countries/regions)



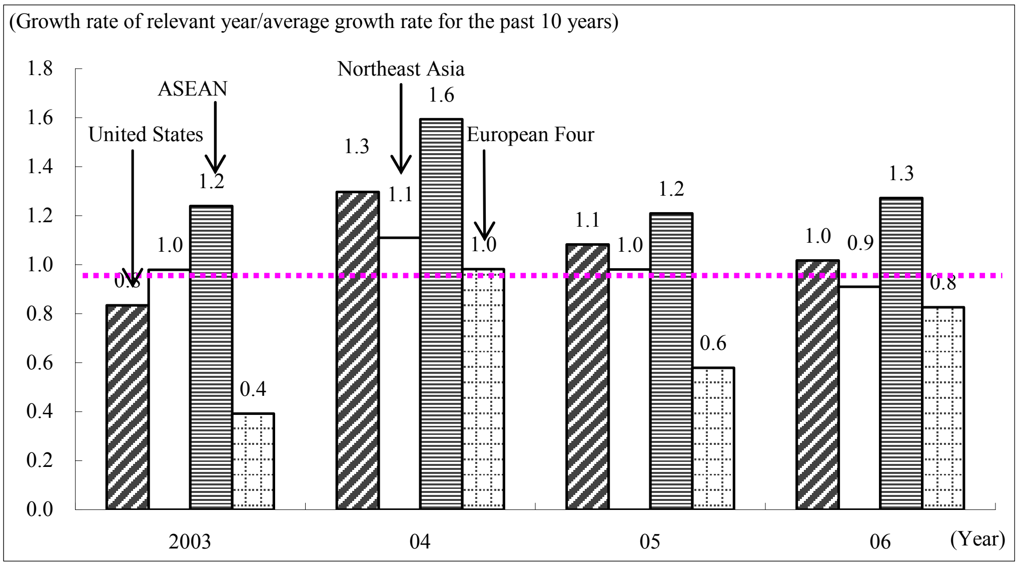


Sources 1. Same as Figure 1-1-1.

2. (1) is calculated with the growth rates of real GDP of countries/regions weighted with the nominal GDP in 2003. For each country/region, refer to the Appendix.

(2) is calculated with the rates of increase of consumer prices GDP of countries/regions weighted with the nominal GDP in 2003. For each country/region, refer to the Appendix.

Figure 9 Growth Performance of the World Economy



Source: Same as Figure 1-1-1 and Figure 1-1-2.

Appendix Weights of Growth Rate of Real GDP and Exports and Imports for the Past 10 Years

(%)

Country/region		1995-2004		Reference	
		Average growth rate of real GDP	Average rate of increase of consumer prices	Share of Japanese exports (2004)	Share of Japanese imports (2004)
(1)	United States	3.2	2.5	25.4	18.1
(2)	Canada	3.3	2.0	1.5	2.4
(3)	Northeast Asia	7.0	—	39.2	38.9
(4)	China	8.7	3.1	14.8	27.2
(5)	South Korea	5.0	3.8	8.9	6.4
(6)	Taiwan	4.6	1.2	8.4	4.8
(7)	Hong Kong	3.6	▲ 0.1	7.1	0.5
(8)	ASEAN	3.9	—	13.9	17.7
(9)	Singapore	5.1	0.9	3.6	1.8
(10)	Indonesia	3.2	14.2	1.8	5.4
(11)	Thailand	3.3	3.4	4.1	4.1
(12)	Malaysia	5.2	2.5	2.5	4.1
(13)	Philippines	4.1	6.0	1.9	2.4
(14)	India	6.2	6.3	0.6	0.8
(15)	European Four	2.0	—	9.8	11.2
(16)	Germany	1.5	1.4	3.8	4.9
(17)	France	2.2	1.6	1.7	2.4
(18)	Italy	1.6	2.5	1.3	2.0
(19)	United Kingdom	2.8	1.6	3.0	1.9
(20)	Euro zone	2.1	1.9	13.3	13.0
(21)	Russia	3.7	25.7	0.6	1.6
(22)	Australia	3.7	2.7	2.4	5.6
Total growth rate of real GDP (1)-(3) + (8) + (14) + (19)-(22) Total rate of increase of consumer prices (1) + (2) + (4)-(7) + (9)-(14) + (19) + (20) + (22)		3.3	2.4	100.0	100.0

Source: 1. Same as Figure 1-1-1.
2. In calculating the average growth rate of GDP for the past 10 years, the average for Russia was from the past nine years from 1996 to 2004.
3. In calculating the average rate of increase of consumer prices for the past 10 years, the averages for Hong Kong and Italy were from the past 9 years from 1996 to 2004. Russia was not included in the average for the past 10 years.
4. The share of Japanese exports in the reference section is according to *Trade Statistics* of the Ministry of Finance.

1. US economy expands at pace slightly above potential growth rate

● The US economy in 2005 expanded steadily despite rising crude oil prices that have continued since 2003. Nevertheless, due to the effects of Hurricane Katrina, among other factors, employment and consumption temporarily slowed down and it is expected that the growth rate will ease somewhat in October-December 2005. It is expected that in 2006 growth that is somewhat above the potential growth rate will still be secured.

● Against this background of economic expansion, the raising

of the policy interest rate since the middle of 2004 has been maintained at a measured pace. Crude oil prices rose to and remained at record high levels and there were concerns about the effects on the economy as a whole through price increases. . The rise in consumer prices, excluding energy, has shown calm movement until now, and the downward pressure on the economy has been limited.

2. High growth centered on China continues in the Asian region

● In China, although the government is implementing macro-controls such as direct regulatory instruments and interest rate increases in response to investment overheating seen in some industries, including the steel industry, since the beginning of 2004, the growth rate in the first half of 2005 was more than 9%. The government is continuing its careful policy management with the aim of a soft landing through macro-controls, and the growth rate in 2005 is expected to be between 9% and 10%. In the "Eleventh Five-Year Plan (2006-2010)," which will be implemented starting in 2006, the existing growth-oriented, investment-led policies have been modified, and policies aimed at sustainable growth toward an end goal of realizing the construction of an all-around well-off society (a somewhat comfortable society) have been indicated. In addition the economic growth rate in 2006 is expected to be between 8% and 9%.

3. A mild recovery relying on foreign demand continues in the euro zone

● In the euro zone, domestic demand temporarily recovered in the second half of 2004 before slowing again in 2005. Meanwhile, the world economy picked up, and with the euro in a depreciating trend since the beginning of the year, exports increased in April-June, and the pace of economic recovery in the second half of the year, driven by exports, is expected to strengthen somewhat. With regard to prices, a rise in energy prices has been observed, but the growth rate of consumer price excluding energy has been stable until now. The GDP growth rate in 2005 is expected to slow to about 1.3% from 2.1% in 2004, and it is expected to recover to about 2.0% in 2006.

4. Risks confronting the world economy in 2006

Regarding risks that the world economy will face in the future, there are downward risks such as rising crude oil prices, a slowdown of the US economy, rapid adjustments to exchange rates and increased long-term interest rates, and a slowdown of the Chinese economy.

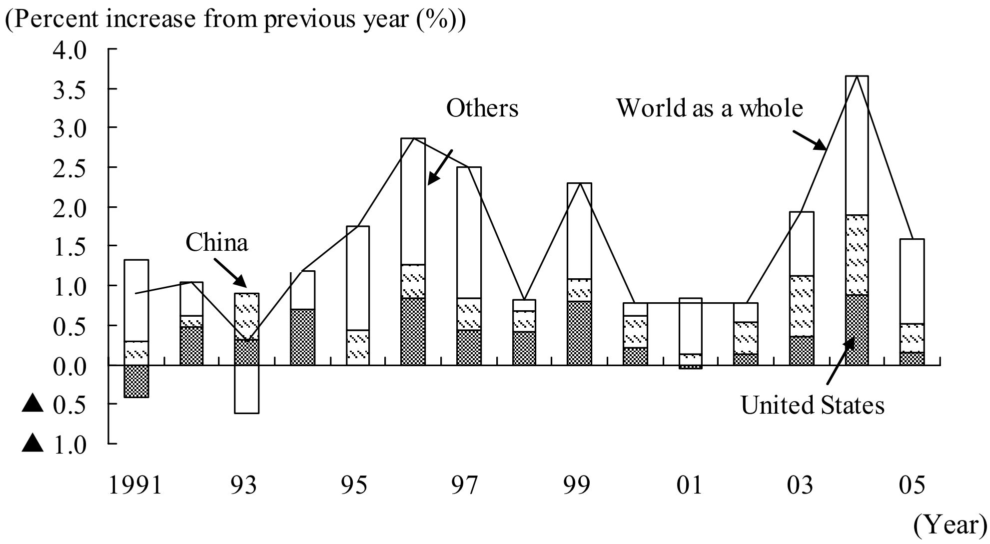
Part1 Key Points of Chapter 2

1. Sharp rise in crude oil prices and its background

● The crude oil price is rising sharply on the international petroleum market. The commodity price (mid-month of delivery) for West Texas Intermediate (WTI), a benchmark on the international petroleum market that began rising in 2003, reached US$55.2/barrel (closing price) in 2004, and was recorded at US$69.8 (closing price), the record high price, on August 30, 2005. Moreover, besides WTI, the price of Brent and Dubai have both been rising substantially on the market for the past few years.

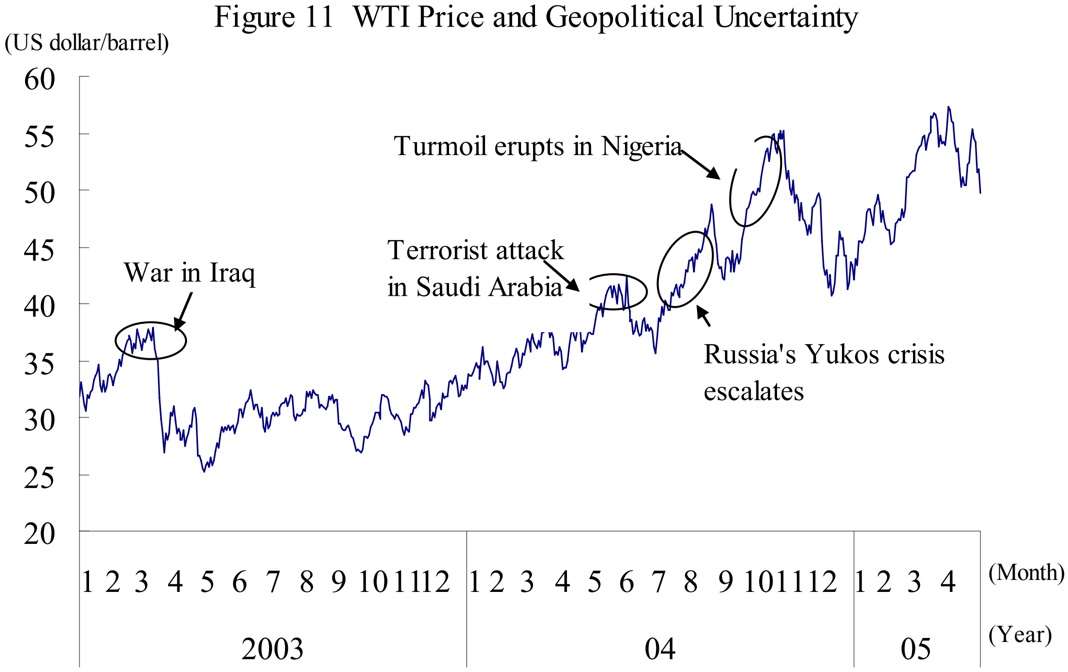
● Constituting the background for this are demand-side factors such as an increase in crude oil consumption (Figure 10), with countries like the United States and China at the core; and supply-side factors like geopolitical uncertainty (Figure 11), underdevelopment of new oil wells (Table 12), and the inadequacy of oil refining capabilities. The influx of speculative funds into the international petroleum market has been seen as another factor.

Figure 10 Growth of Global Crude Oil Consumption



Source: IEA, *Oil Market Report*.

Figure 11 WTI Price and Geopolitical Uncertainty



Source: Bloomberg and other news reports.

Table 12 Predicted Production Volume of Crude Oil

(Unit: 1 million barrels)

	2004	2010	2020	2030
North America	9.7	10.5	8.8	7.4
Europe (OECD member states)	6.0	4.4	3.1	2.3
Latin America	3.7	4.7	5.5	6.1
Russia	9.2	10.7	10.9	11.1
Other	18.1	21.1	21.1	19.2
All non-OPEC member states	46.7	51.4	49.4	46.1

Source: International Energy Agency (IEA), *World Energy Outlook 2005.*

2. Impact on the world economy of the sharp rise in crude oil prices

● The rise in crude oil prices is accompanied by the effect of transferring income from oil consuming countries to oil producing countries. In addition, it also constricts corporate profits through the rise in the cost of procuring raw materials, as well as leads to a reduction in the real household income through an increase in the cost of petroleum products and so forth.

● According to various forecasts, from 2005 to 2006 the price of crude oil (WTI commodity price) is expected to shift into the high-level range of US$60.

● Although the global rate of price inflation is moving upwards slightly due to the rise in crude oil prices, it still remains at a mild level. The core CPI is generally mild in leading industrialized countries, and the prospect of inflation is also kept relatively in check. Inflationary pressures in Asian countries, however, are growing somewhat stronger than in developed countries.

● It is believed that the impacts of the rise in crude oil prices will be minor in developed countries. One factor seems to be that as a result of their orientation toward energy conservation and their shift toward "soft," or service-oriented economies, amount of crude oil consumed per one unit of real GDP (energy intensity) is being reduced, primarily in leading industrial countries. Because of this it is believed that the impact on the

real economy has been softened substantially.

● On the other hand, looking at Asian countries over the last 30 years or so, energy intensity has not improved, and the energy efficiency remains at a low level. Although many countries have restricted the impact of the sharp rise in crude oil prices on commodity prices through the use of fuel subsidy systems, it is anticipated that if the price of crude oil is continuously maintained at a high level then there will be a negative impact on the economy through an increase in the amount of fiscal deficits.