World Economic Trends
The Spring Report in 2011

— The World Economy at a Historic Turning Point:
"Accelerated Globalization" and Growing Presence of Emerging Countries—
(Summary)

May 2011
Cabinet Office
Government of Japan

Purpose

- Japan is plagued with a composite crisis including the Great East Japan Earthquake of March 11, 2011, and such pre-disaster challenges as economic stagnation and fiscal deterioration.
- Meanwhile, however, the world economy has been moving instead of halting. The world economy, though it keeps recovering, faces a plenty of risk factors, such as soaring crude oil prices and European sovereign risks.
- In order to recover from the shock of the Great East Japan Earthquake and revitalize Japan, we must accurately detect the direction in which the world economy is moving and find Japan's desirable future course. We must also add momentum to Japan's reconstruction and revitalization in line with the overall world economic trends.
- The "World Economic Trends" provide indispensable materials for working out Japan's revitalization strategy.
  - Chapter 1 analyzes the structure of the world economy, which is at a historic turning point with the growing presence of emerging countries.
  - Chapters 2 and 3 consider present and future conditions and risk factors of the world economy.

1-1 Commodity Price Spikes and Their Background (1) – Global Actual Demand Expansion Backed by Economic Growth of Emerging Countries –

- Crude oil, grain, and mineral product prices soared rapidly in the early 2000s. Following a steep fall in mid-2008, they have risen again since the summer of 2009 (Figure 2).
  - Background: (1) Economic growth of emerging countries (2) Commodities transformed into financial instruments
- <u>Background of spikes 1: Global actual demand expansion backed by economic growth of emerging countries</u>
  - The change of wheat-, copper-, and oil-demand in the past decade: Emerging countries contributed to most of the growth in consumption and imports (Figure 2).
  - Background of demand growth: (1) Population growth, (2) Diffusion of automobiles and increasing meat demand as improving living standards, (3) Development of tradable goods industries through industrialization

Figure 1 Trends in Commodity Prices: Sharp rises in the 2000s

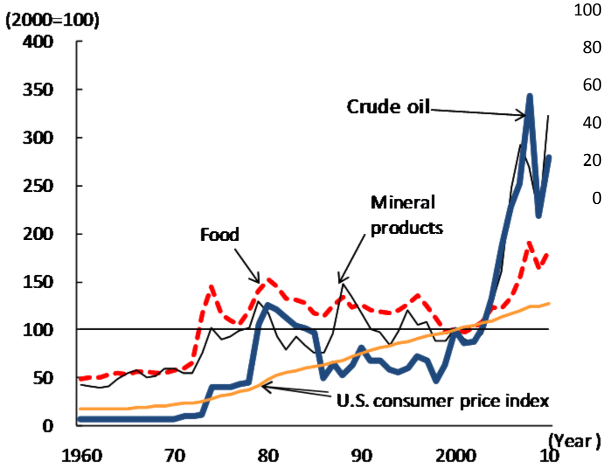
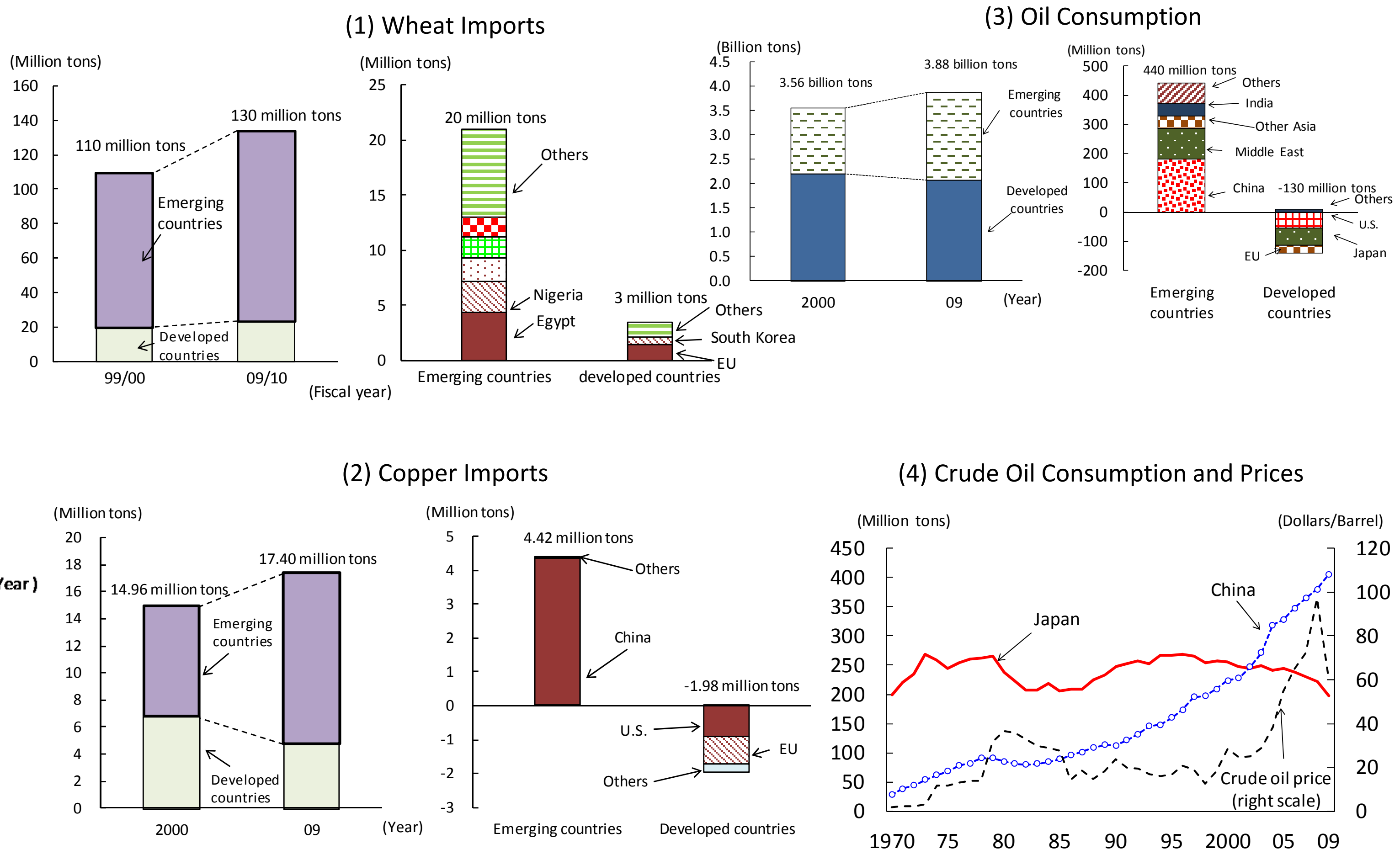


Figure 2 Recent Trends in Major Commodity Prices: Emerging countries contributed to most of the demand growth



1-2 Commodity Price Spikes and Their Background (2) – Commodities Transformed into Financial Instruments –

- Background of spikes 2: Expansion of trading and growing presence of new investors – Commodities transformed into financial instruments --
  - Trading expanded rapidly in the mid-2000s and thereafter. Following a decline after the global financial crisis, trading has increased again (Figure 3).
  - Particularly, market players other than producers and traders have expanded trading rapidly (Figure 4). Behind the rapid trading expansion has been the development of commodity funds, exchange-traded funds, and other financial instruments involving crude oil, gold, and other commodities (Figure 5).
- Effects of commodities transformed into financial products on commodity prices
  - The correlation between changes of commodity and stock price has been growing (Figure 6). As commodity prices had had little correlation with stock prices until the early 2000s, commodities had been positioned as an alternative investment target for stocks. At present, however, commodities have been transformed into financial instruments susceptible to the effects of risk-oriented markets.

Figure 3 Trends in Trading Volumes (crude oil, wheat): Sharp growth

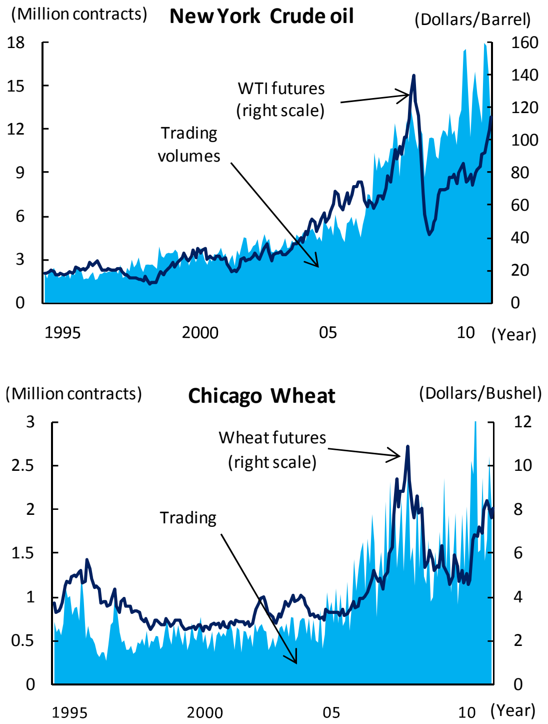


Figure 4 Shares for Market Participants (wheat, crude oil): Shares expanded rapidly for those other than producers and traders

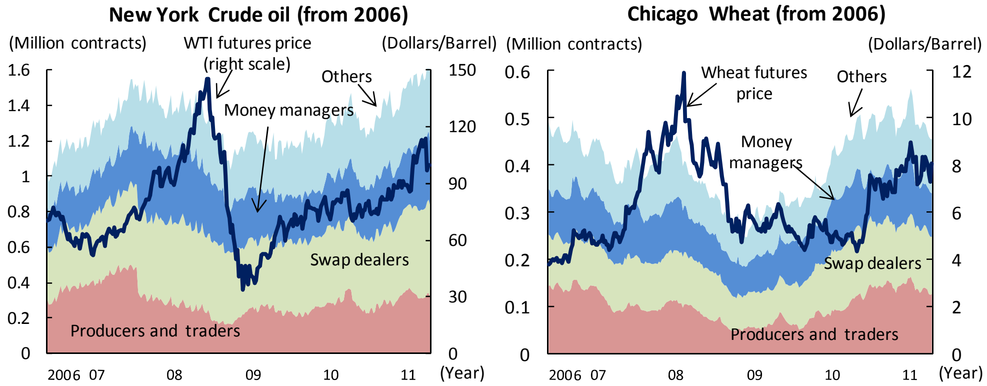


Figure 5 Trends in the balance of Commodity ETFs: Sharp growth

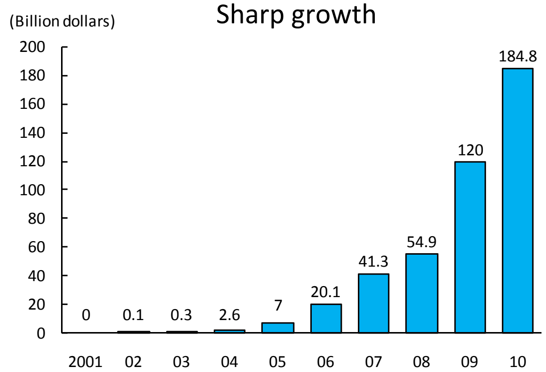
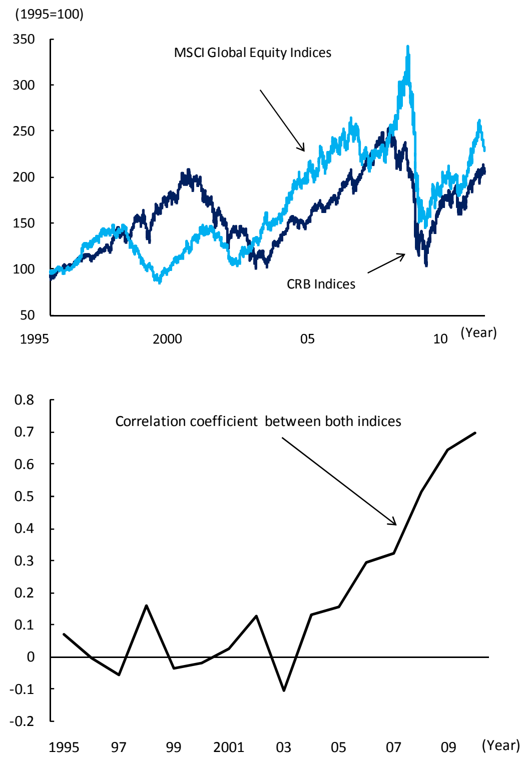


Figure 6 Commodity and Stock Prices: Growing correlation

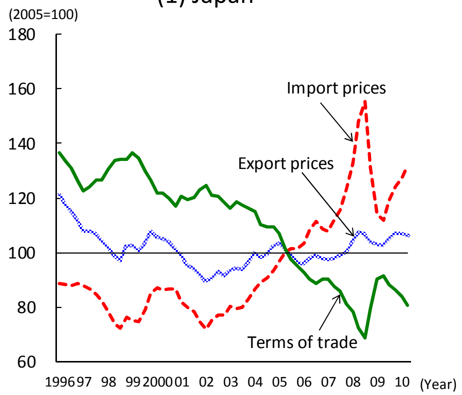


2. Changes in Terms of Trade and International Income Transfers

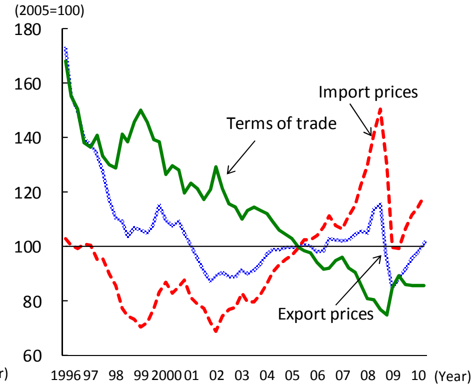
- Commodities have expanded their share of world trade year by year on the back of growing global demand for resources and their price hikes.
- Terms of trade (Figure 7): Terms of trade have deteriorated for Japan and South Korea. Import prices have soared on commodity price hikes while export prices have been held down. In Germany and other European countries, however, export prices have soared in line with import price hikes. Terms of trade have thus remained stable for these countries.
- Trading gains/losses (Figure 8): Trading losses have expanded rapidly for Japan and South Korea. No trading losses have emerged for Germany.
- Differences in export structures (Figure 9) , exchange rates, and import structures affect trading gains/losses.
  - Germany: Exports to other EU countries account for two-thirds of Germany's overall exports. Intra-industry trade among industrial nations with similar income and technological levels accounts for most of Germany's external trade. Germany can control product prices to some extent through its product differentiation and pass raw material price hikes on to product prices.
  - Japan: Exports to other Asian countries account for about half of its overall exports. Japan takes advantage of technological and other gaps for interindustry trade. Price competitiveness is a key factor. Also, in areas where non-price competitiveness cannot be exercised sufficiently for intra-industry trade, Japan must implement price competition with South Korea and some other countries. Therefore, it is not easy for Japan to pass raw material price rises on to product prices.

Figure 7 Changes in Terms of Trade for Each Country

(1) Japan



(2) South Korea



(3) Germany

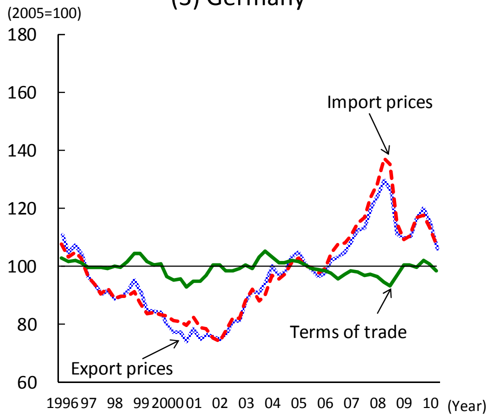
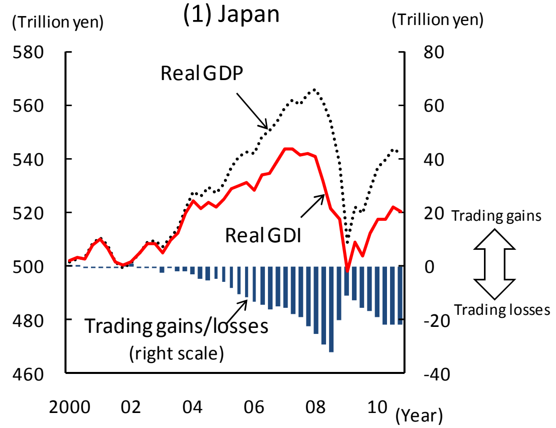
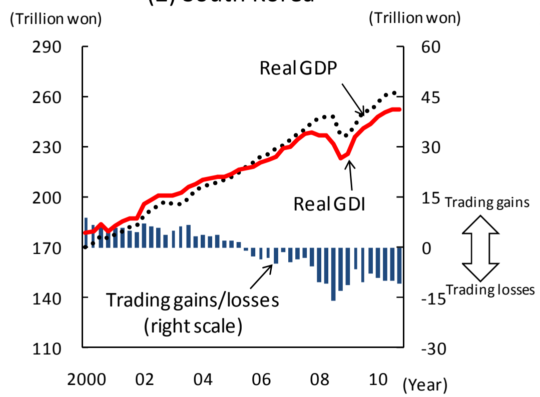


Figure 8 Changes in Trading Gains/Losses

(1) Japan



(2) South Korea



(3) Germany

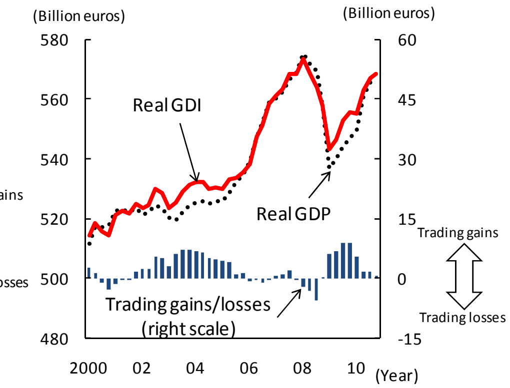
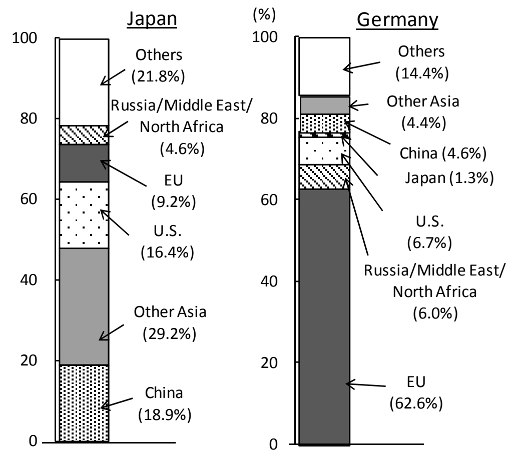


Figure 9 Japan's and Germany's Export Destinations (2009)



※Trading gains/losses: A concept for indicating income transfers accompanying price fluctuations for external trade. If the price of a product is raised, the product's importer will be required a higher price and incur a loss, and its exporter will get a gain.

3. Necessity for Strategies Based on Commodity Price Spikes

- Commodity prices may continue rising on an increase in demand throughout the entire world economy, including emerging countries, intensifying competition for resources.

- Based on electricity constraints and nuclear power plant safety concerns that caused by the Great East Japan Earthquake, we plan to thoroughly reconsider Japan's energy policy and <u>work out a new energy strategy. In working out the new strategy, we should take into account the basic premise that energy prices will continue rising on the back of a global demand expansion.</u>

- <u>Efforts to overcome energy supply constraints are important</u>, including the promotion of renewable energy introduction and diffusion.
  - ➢ Renewable energy: Renewable energy supply has nearly doubled from the 1973 oil crisis. But its share of primary energy supply has remained unchanged, at about 13% (Figure 10).
    - ✓ Renewable energy development investment has increased but has fallen short of reaching fossil fuel or nuclear development investment levels (Figure 11).
    - ✓ Technological development is required for commercializing renewable energy sources and they are costly. Therefore, investment in renewable energy has failed to lead to any increase in renewable energy's share of total energy supply.

- Commodity price hikes will continuously lead to income transfers from resources-importing countries to their exporters. Instead of implementing price competition with emerging countries, <u>Japan should work out an external trade system where it could boost non-price competitiveness through product differentiation and allow commodity price hikes to be passed on to export prices without deterioration in terms of trade.</u>

Figure 10 Trends in Primary Energy Supply: Renewable energy's share has remained unchanged

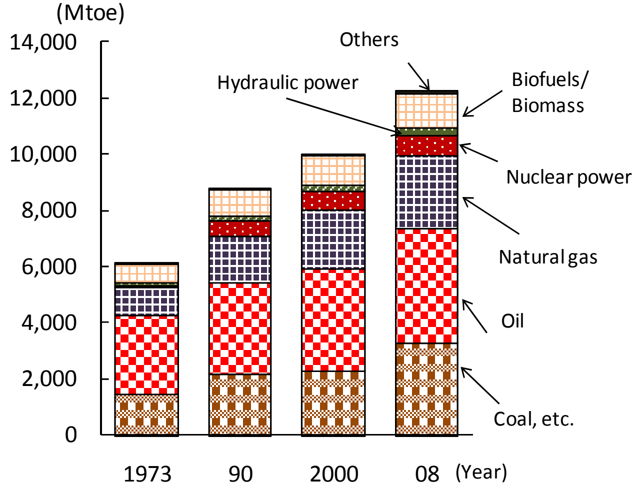
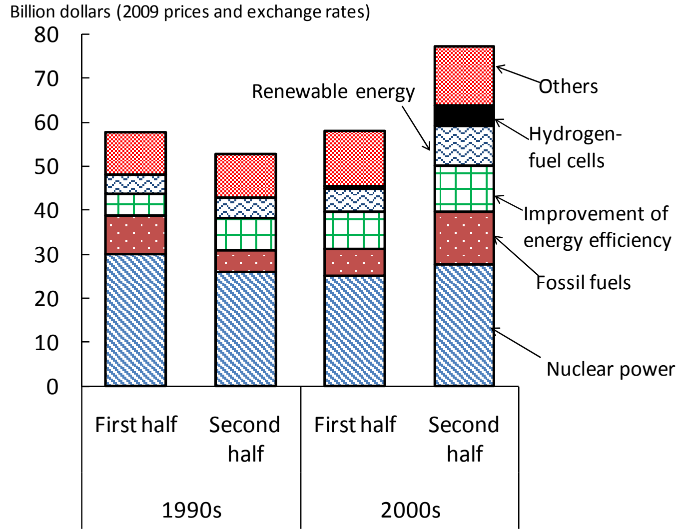


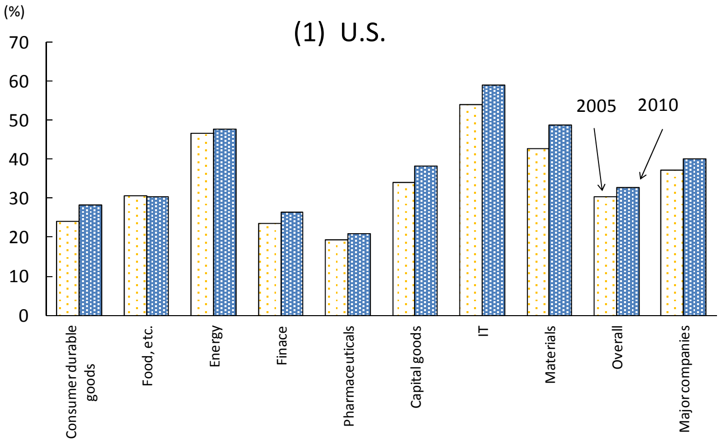
Figure 11 Breakdown of Energy Investment in IEA Countries

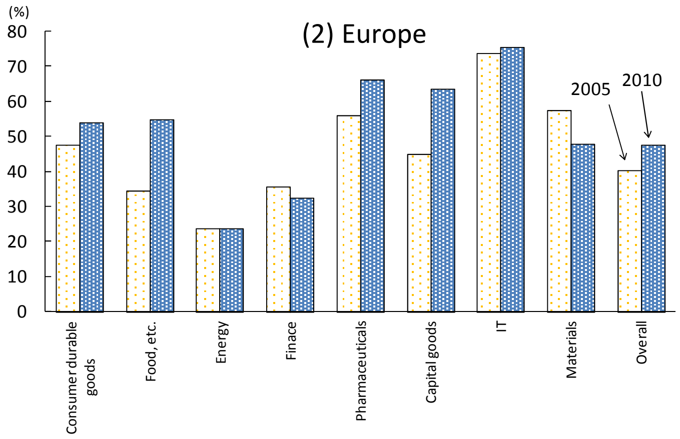


1. Global Capital Flows and Moves of Companies in Industrial Countries

- Foreign direct investment and securities investment: Such investment has increased substantially from the levels of the 1990s, with emerging countries expanding their investment share.
- Moves of companies in developed countries: Particularly, big companies have stepped up global operations across national borders. <u>The weight of their operations in emerging countries has increased.</u>
  - Overseas sales' share of overall sales for European and U.S. companies has risen over the five years since 2005 (Figure 12). Such share for big U.S. companies stands at around 40%. Those in information technology, materials, energy and some other industries feature high overseas sales shares. Meanwhile, overseas sales shares for Japanese companies have declined.
  - In the automobile industry, sales in such regions as Asia have expanded (Figure 13).

Figure 12 Overseas Sales Shares for Major Companies: Such shares have increased for European and U.S. companies but declined for Japanese firms.





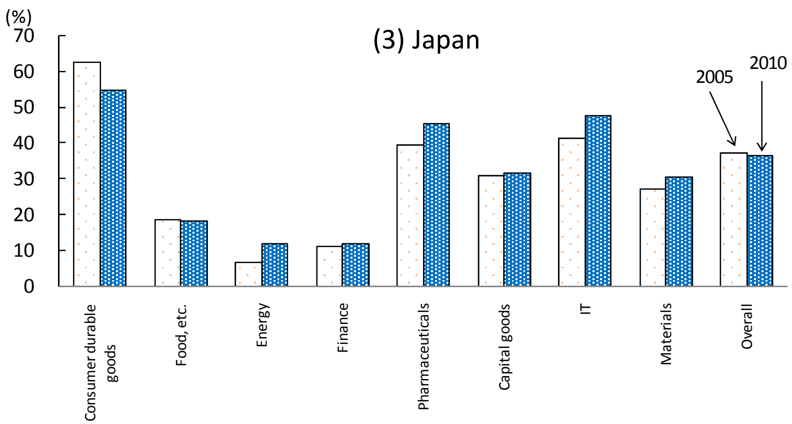
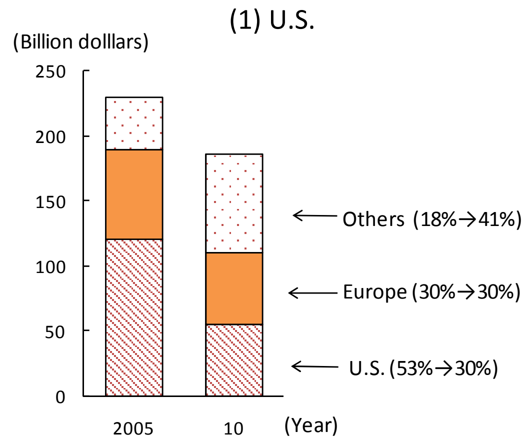
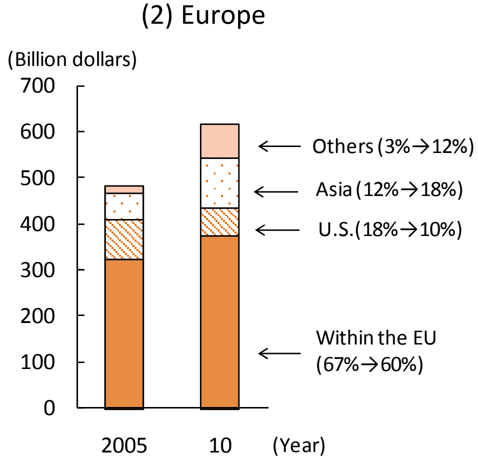
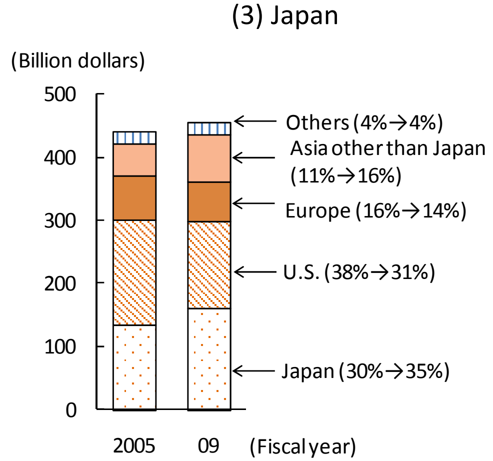


Figure 13 Automakers' Sales: Sales in Asia have expanded







2-1 Growing Risks of Global Fund Flows (1) – Global Imbalances Are Expanding Again –

- The global imbalance problem was a macroeconomic factor behind the global financial crisis.
  - Due to U.S. over-consumption and emerging countries current account surplus expansion, since the early 2000s, massive funds have flown to the United States and Europe from emerging countries that have abundant money supplies.
  - As China has increased its holdings of U.S. Treasury securities, even U.S. policy rate hikes fail to lead to a rise in U.S. Treasury yields (Figure 14).
  - Financial institutions chasing higher-return assets held massive subprime mortgage-backed securities without implementing sufficient risk management, triggering the global financial crisis.
- Global imbalances narrowed in 2009 after the global financial crisis, before expanding again in 2010 (Figure 15). Behind the expanding imbalances are investment-savings balance and exchange rate realignment problems.
- Investment-savings balance: In the United States, into which money has flowed, the government sector is short of funds due to aggressive fiscal spending. In China, from which money has flowed out, the savings rate has continued rising.
- Exchange rate realignment: The exchange rate for the renminbi or yuan currency of China, a current account surplus country, has been raised gradually. But some people see the Chinese currency as required to appreciate further.
- While the imbalances have expanded, China has expanded its holdings of U.S. Treasury securities and agency securities issued by government-sponsored enterprises year by year (Figure 16). Abundant funds in China and other emerging countries finance U.S. government spending and indirectly support the residential market.

Figure 14 Trends in China's U.S. Treasury Securities Holdings and U.S. Interest Rate:
The benchmark Treasury yield remained low despite policy rate hikes

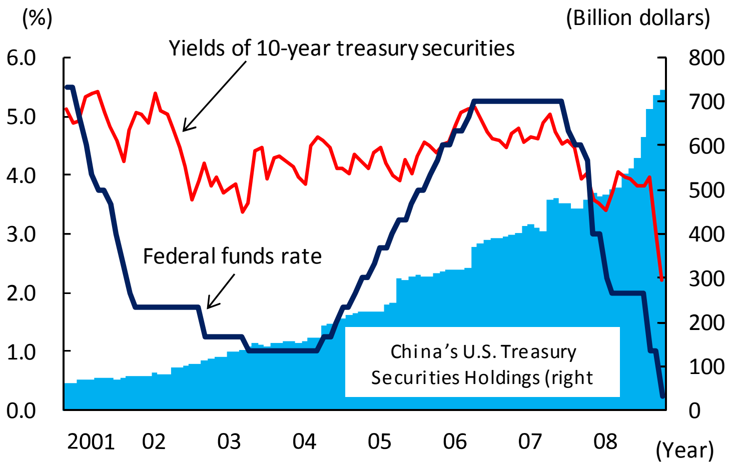


Figure 15 Trends in Current Account Balances: Expanding again

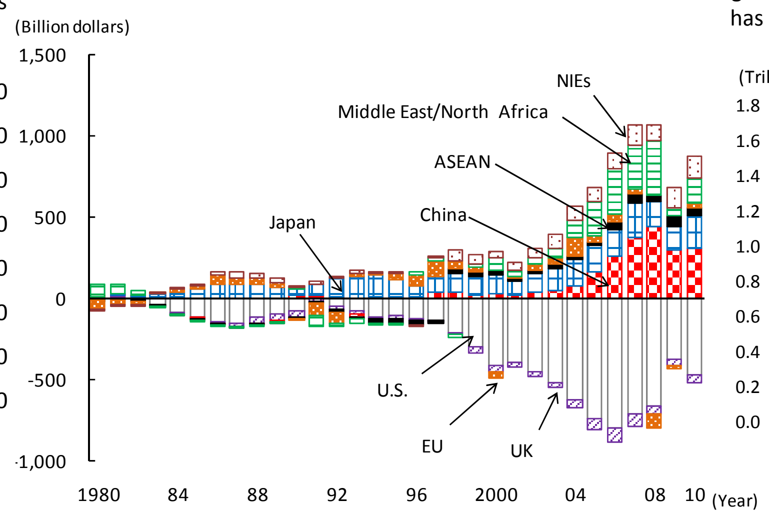
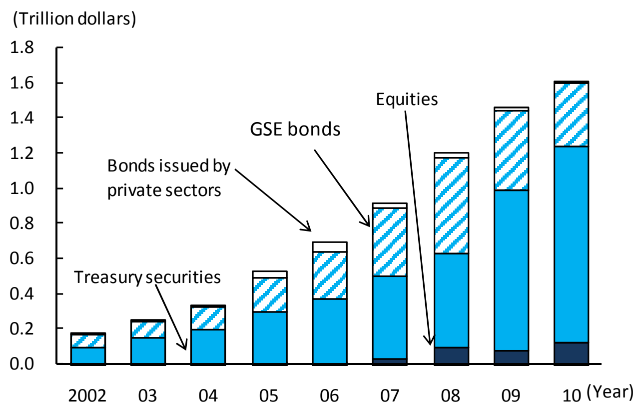


Figure 16 Trends in China's U.S. Treasury Securities Holdings: China has expanded Treasury and GSE securities holdings year by year

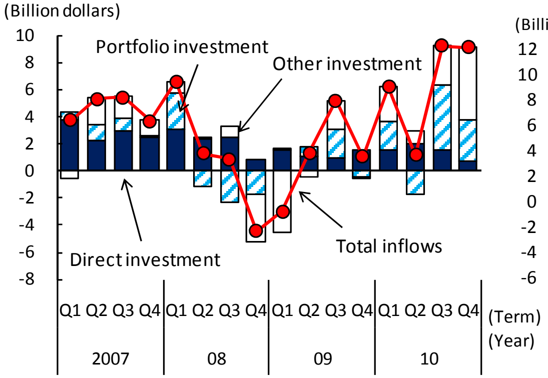


2-2. Growing Risks of Global Fund Flows (2) – Bubbles in Emerging Countries –

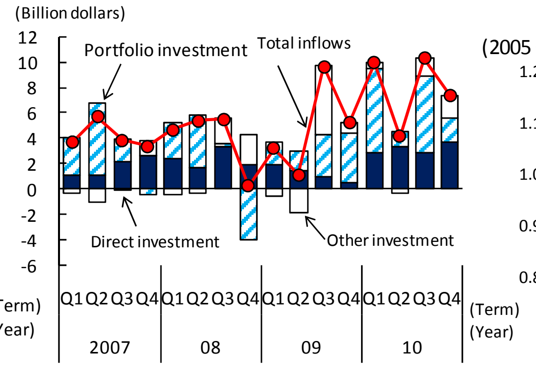
- Emerging countries` economies have been overheating. Consumption prices and real estate prices have risen. Interest rate hikes and other monetary tightening measures have been unable to stop rises in goods and real estate prices. Meanwhile, monetary policy has remained accommodative in industrial countries.
- While global imbalances have expanded, <u>part of funds flowing into the United States and other industrial countries have been invested back into emerging countries by financial institutions and investors seeking to take advantage of economic growth and interest rate gaps for gaining higher returns.</u>
  - In Thailand and Indonesia, inflows of portfolio and other investments (including loans) have expanded rapidly since mid-2009. In China, other investment inflows have increased rapidly since the second half of 2009 (Figure 17).
  - In China and Indonesia, Marshallian k has risen, indicating that money supply could have expanded faster than the real economy (Figure 18).
- At present, these countries have sufficient foreign exchange reserves. If their external debts exceed their foreign exchange reserves on continued fund inflows, however, <u>they may face a substantial depreciation of their currencies and insecurity in their financial systems in the event of foreigners' rapid fund withdrawals</u> like those that triggered the Asian currency crisis.

Figure 17 Fund Inflows into Emerging Countries: Rapid expansion

(1) Thailand



(2) Indonesia



(3) China

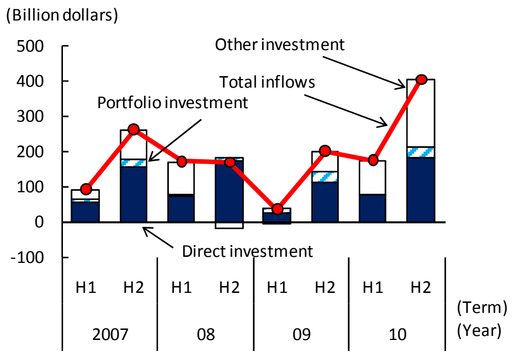
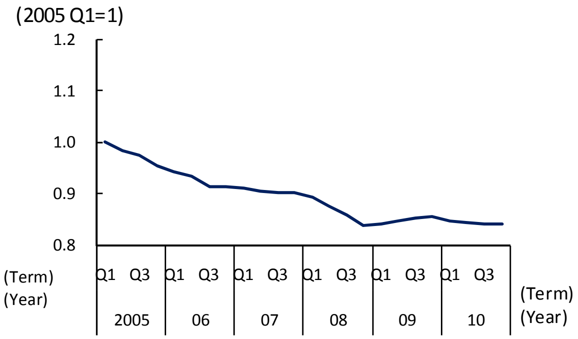
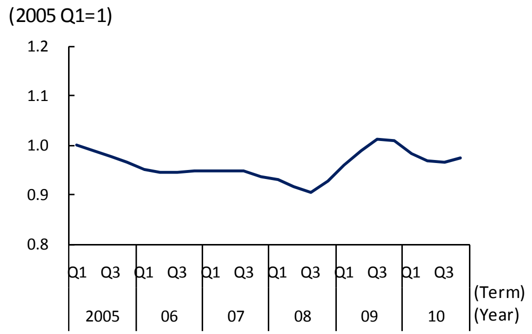


Figure 18 Trends in Marshallian k in Asian Emerging Countries: Rising in Indonesia and China

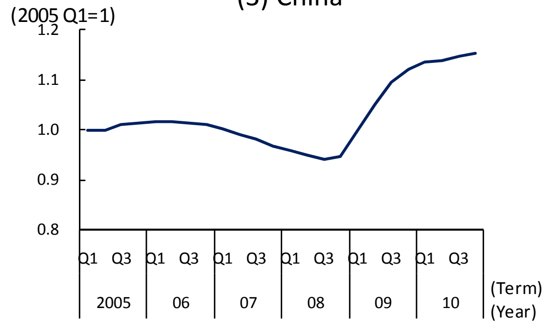
(1) Thailand



(2) Indonesia



(3) China



(Note) Marshallian k = Money supply / Nominal GDP

2-3. Growing Risks of Global Fund Flows (3) – Loosening U.S. Budget Discipline and Financial Systemic Risk –

- Ample funds from emerging and oil-producing countries have financed U.S. budget deficits. QE2 has eventually supported part of government spending. If such conditions remain unchanged, U.S. budget discipline may loosen because interest rates cannot impose discipline on the market.
  - Of U.S. Treasury securities, the Federal Reserve Board holds 11% and the external sector 47%. Particularly, emerging and oil-producing countries' share of the external sector's U.S. Treasury holdings has expanded fast. China's share increased from 8% in 2001 to 20% in 2010 (Figure 19).
- Financial institutions in industrial countries have grown more oligopolistic and larger (Figure 20). If thorough risk management or the effectiveness of international regulations and frameworks is not secured appropriately, financial systemic risks may increase.
  - While the number of banks in the United States fell from 10,000 in 2000 to less than 8,000 in 2010, their gross assets doubled during the decade.
  - The Basel III bank capital rules will take effect gradually in each country from 2013. The United States has enacted "the Dodd-Frank Act". However, it has fallen short of resolving multiple regulators' complicated regulatory and supervisory arrangements and other problems peculiar to the U.S. financial system. Also, its specific regulations will be set in the future.

Figure 19 U.S. Treasury Securities Holdings: The foreign sector holds 47% and emerging countries' shares of the external sector holdings have expanded

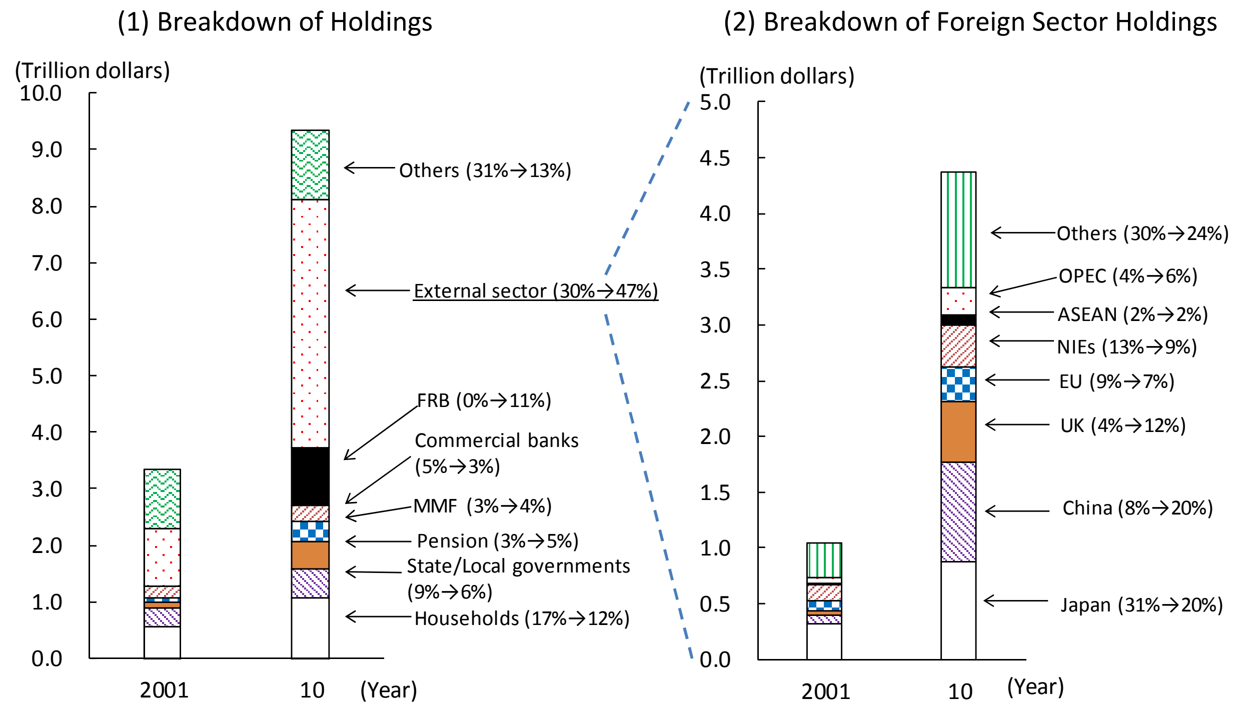


Figure 20 Trends in U.S. and EU Financial Institutions: Growing more oligopolistic and larger