3. Economic Policy Responding to Growing Risks

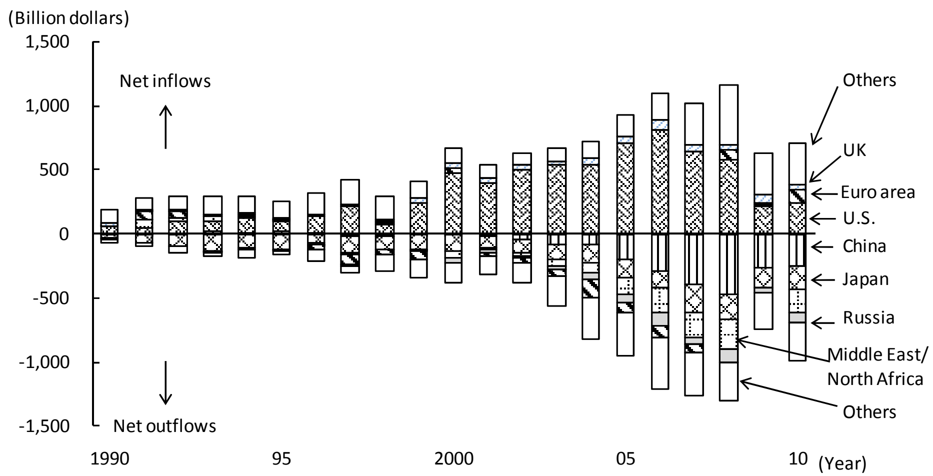
- In the 2000s, emerging countries' presence in global capital flows expanded remarkably. The weight of business operations in emerging countries increased for companies in developed countries. Globalization has accelerated.

- Global imbalances have expanded against the backdrop of national investment-savings balance and exchange realignment problems.
- International fund flows have expanded (Figure 21). Particularly, emerging countries' ample funds have worked to finance U.S. budget deficits. These conditions include risk factors such as (1) loosening U.S. budget discipline and (2) the possibility that bubbles could be generated in emerging countries as financial institutions and investors invest in these countries in order to earn higher returns. There is also the possibility of increasing financial systemic risks.

- While global economic and financial integration makes progress, each country's optimum policy for itself could fail to produce optimum results at the global level. It is important for countries to deepen policy cooperation in a bid to reduce such risks for the entire international community.

- Meanwhile, the expansion and diversification of major international society players may make it difficult to proceed with policy cooperation in many areas. Japan's policy authorities <u>should be united to check risks at home and abroad, detect future risks and prevent the nation from being exposed to risks by securing prudent economic policy management, particularly budget sustainability, to maintain a stable macroeconomic environment, even under the risk-abundant international finance environment.</u>

Figure 21 Trends in Net Investment Inflows in the World: Expanding again



1. Overview of World Labor Market

- As emerging countries' share of the world's labor forces has increased, the weight of labor forces in these countries has increased.
  - The labor force has moderately increased in the United States and the European Union and moderately declined in Japan since 2000. But it has grown in ASEAN member countries, Brazil, and other countries.
  - Employment: Employment in such regions as Asia have grown faster than in industrial countries. Industrial countries have seen an employment decline in the manufacturing sector and an increase in the services sector. Meanwhile, emerging countries have seen an employment increase in the manufacturing sector. The center of gravity of the manufacturing sector has been shifting to emerging countries (Figure 22).
  - Improvement in the quality of labor forces in emerging countries: Higher education rates have steadily increased (Figure 23).
- Wages: Wage growth has slowed down in developed countries since the 1980s and remained high in China. Wage gaps between industrial countries and China have slightly narrowed since the second half of the 1990s (Figure 24).

Figure 22 Manufacturing Sector Employment: Increasing in emerging countries

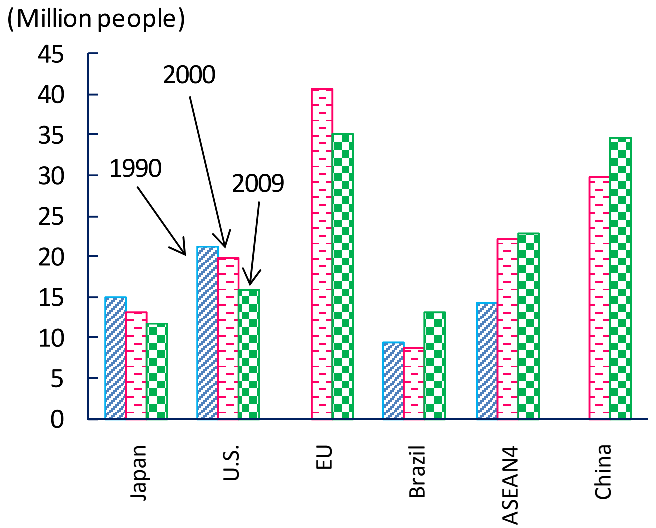


Figure 23 Higher Education Rates: Rising in emerging countries as well

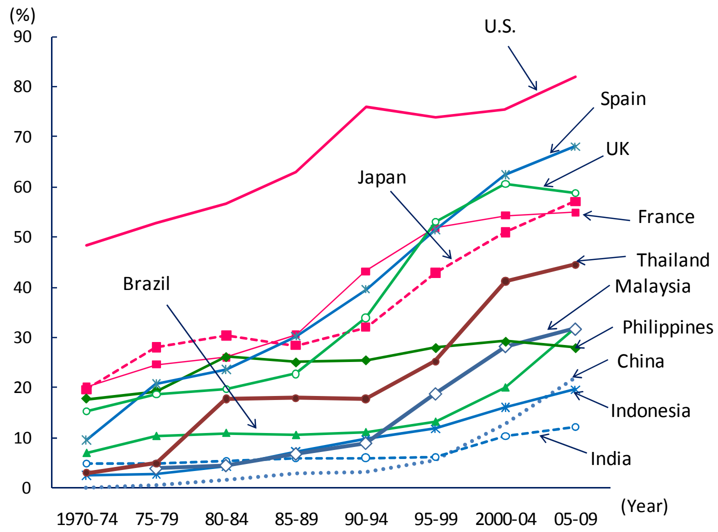
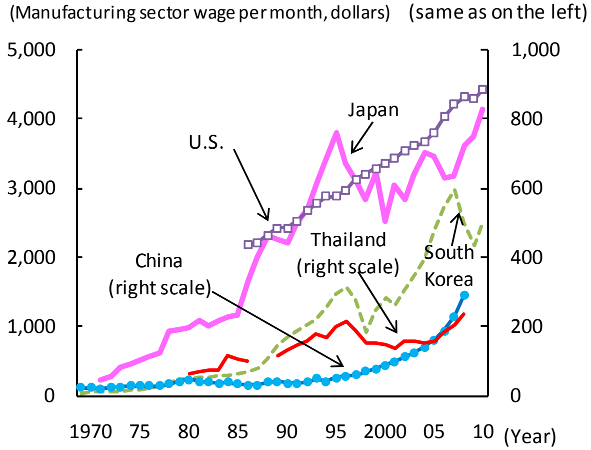
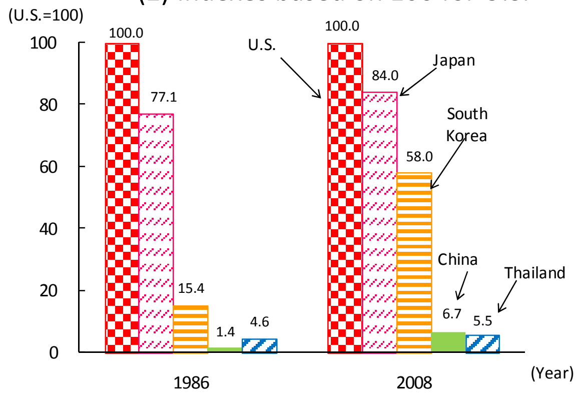


Figure 24 Wage Levels: China's gaps with industrial countries have tended to narrow

(1) Trends



(2) Indexes based on 100 for U.S.



2. International Labor Transfers

- International immigrants move from emerging/developing countries to developed countries (Figure 25)
  - Since the 2000s, many immigrant workers from China and India as well as those from neighboring countries or countries closely related to their home countries in terms of culture and history have moved to major developed countries. The number of Chinese and Indian workers doing so has increased (Figure 26). The majority of such workers are unskilled workers in services, sales, and other areas.
- Chinese and Indians account for a remarkable share of foreign students studying in major industrial countries. Particularly, Chinese students' shares have increased in many major industrial countries (Figure 27).
- The settlement of immigrant workers and students has contributed to expanding local labor forces to some extent (Figure 28).

Figure 25 Trends in International Immigrants (net, flow): From emerging/developing countries to industrial countries

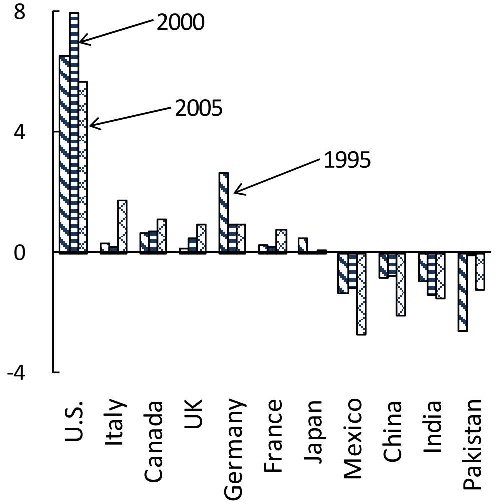


Figure 26 Trends in Immigrant Workers Moving to Industrial Countries and Their Breakdown (net, flow): Chinese and Indians are dominant

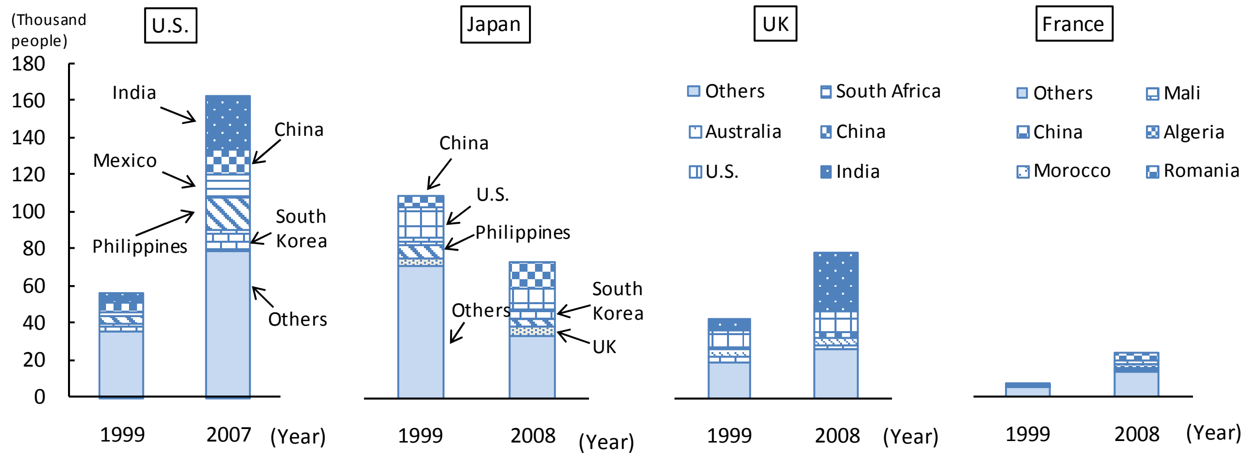


Figure 27 Foreign Students in Developed Countries and Their Breakdown: Chinese and Indians are dominant

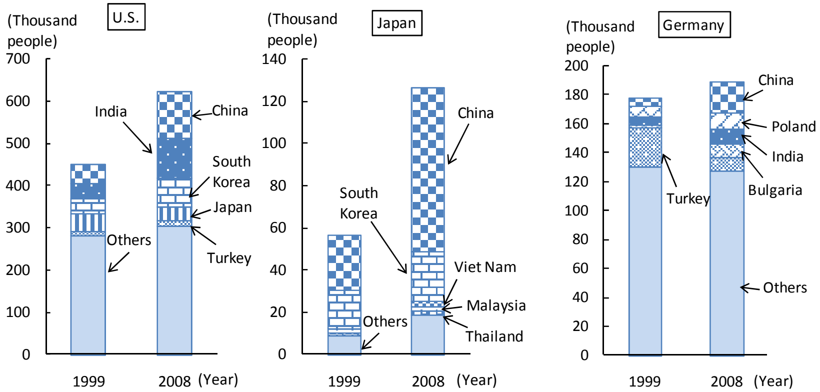
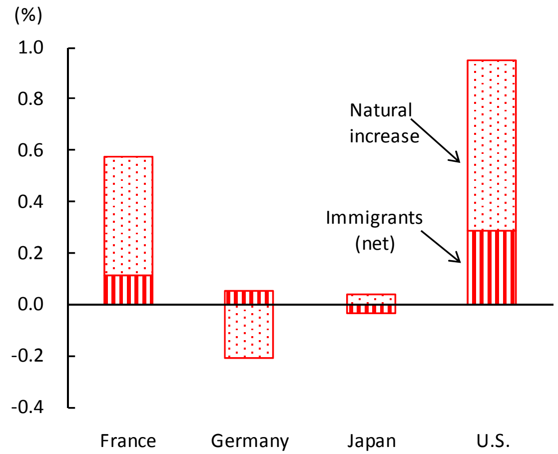


Figure 28 Immigrants' Contributions to Population Growth in Developed Countries (2007)



3. Responses to Structural Changes in World Labor Market

- Emerging countries’ presence has gradually grown in world labor market.
- As trade and investment have expanded, the center of gravity of manufacturing workers has shifted from developed countries to emerging countries. Globalization has accelerated in some areas, such as wage gaps narrowed through trade and investment.
- International labor transfers, though tending to increase, vary from country to country or region to region. It is difficult to conclude that globalization of the labor market has made as much progress as that of goods and capital.

＜Challenges＞

- <u>In developed countries</u> facing a severe employment situation, including an employment slowdown and high unemployment rates, <u>the improvement of workers’ skills and labor transfers to advanced areas are important.</u> Efforts to create new jobs are also important.
- Even in Asian and other <u>emerging countries, the productive population’s share of the total population will peak soon</u> (Figure 29). The population bonus era, featuring abundant available labor, will come to an end. <u>The improvement of labor productivity is required, along with the efficient utilization of labor.</u>
- The settlement of advanced foreign human resources in some countries can contribute to increasing such countries working populations, promoting the diversification of human resources at their companies and improving their international competitiveness (Figures 30 and 31).l

Figure 29 Productive Population’s Share of Total Population: Peaking soon

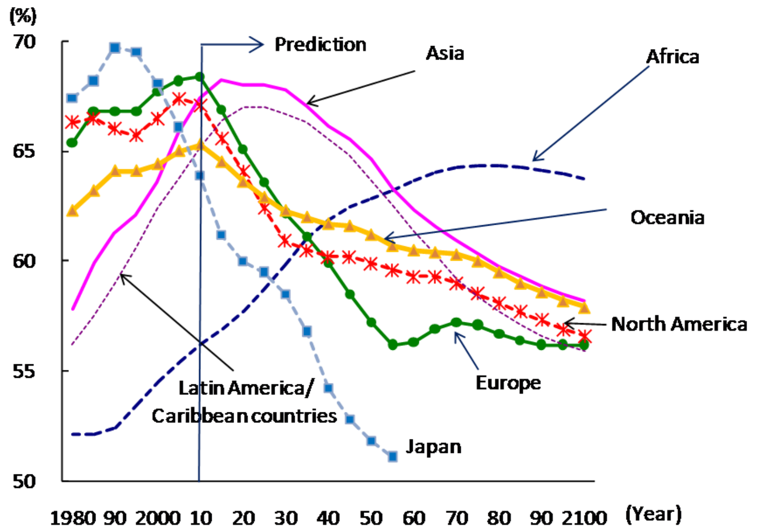


Figure 30 Share for Foreigners Who Acquire Doctorates (in Science and Technology areas) and Settle in the United States

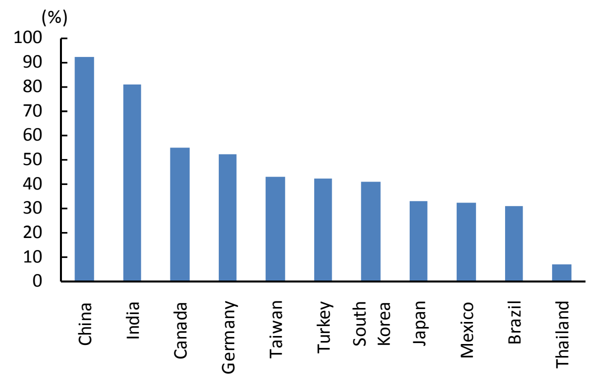
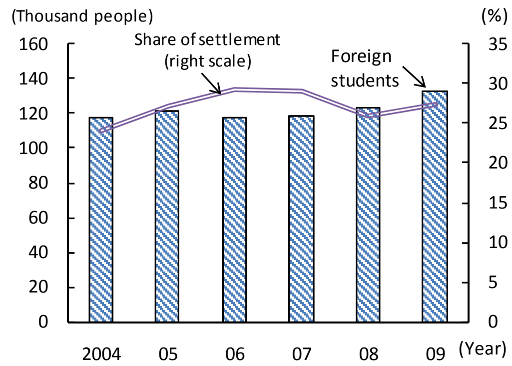


Figure 31 Share for Foreign Students Who Acquire Doctorates and Settle in Japan



- In the world economy over the next two decades, the presence of emerging countries, particularly China and India, will increase despite their structural demographic changes (Figure 32).
- The growing presence of China and India should be <u>called "revival" in the long historical context.</u>
  - In 1820, China (during the Qing dynasty) accounted for about one-third of world GDP against only 1.8% for the United States. While Europe and the United States took advantage of technological innovation to dramatically improve productivity and achieve economic growth in the industrial revolution and thereafter, China's share of the world economy declined rapidly (Figures 33 and 34).
  - China's per capita GDP (on a market rate basis) now stands at 8% of the U.S. level and is expected to increase to some 30% of the level by 2030 (Figure 35).

Figure 32 Long-term GDP Share Changes: Growing presence of emerging countries

(1) On a market rate basis (2) On a PPP (purchasing power parity) basis

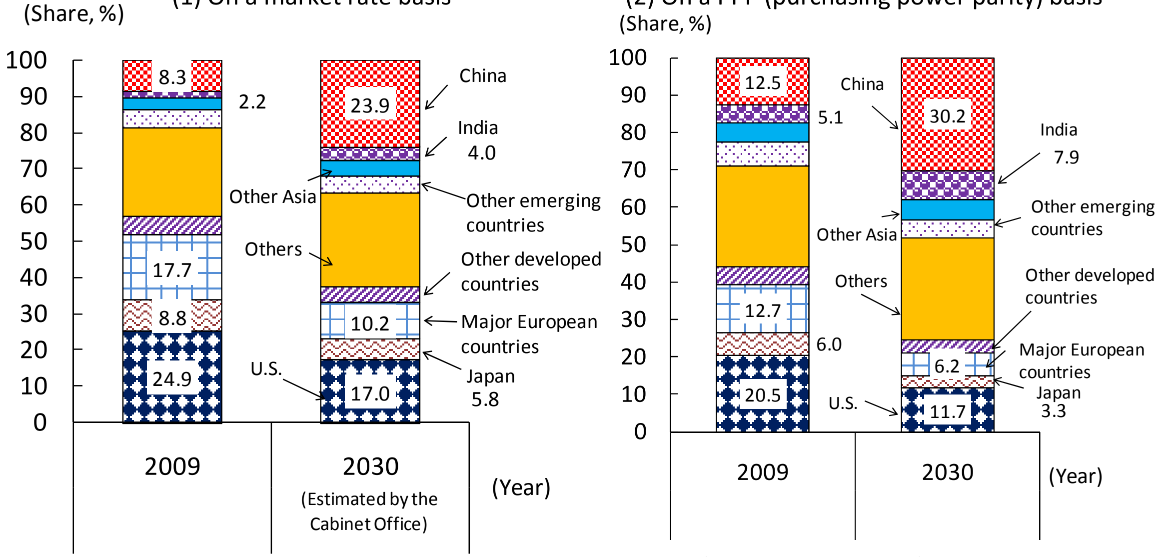


Figure 33 World GDP Breakdown (1820, 1870, 1950) : China and India had a great presence before the industrial revolution

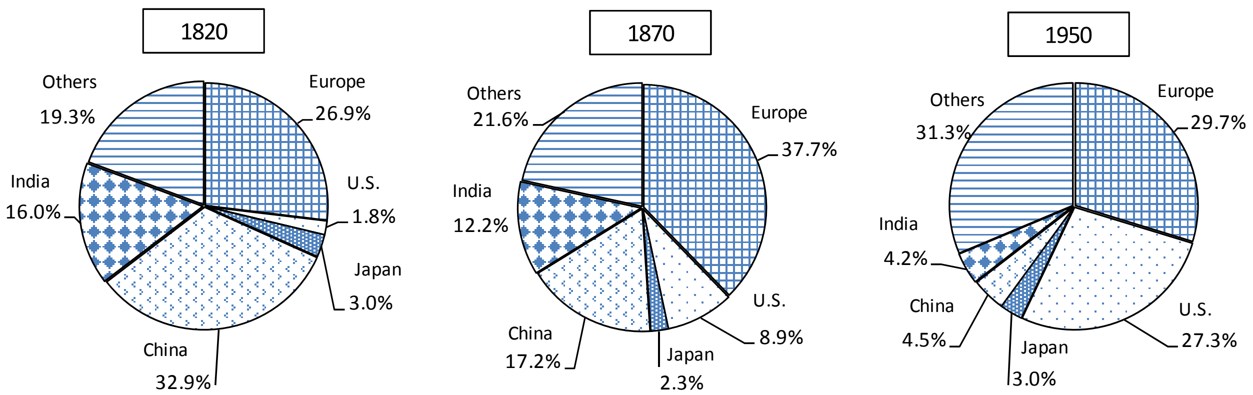


Figure 34 Trends in Per Capita GDP (1820, 1870, 1950): Rapid increases seen in Europe and the U.S. since the industrial revolution

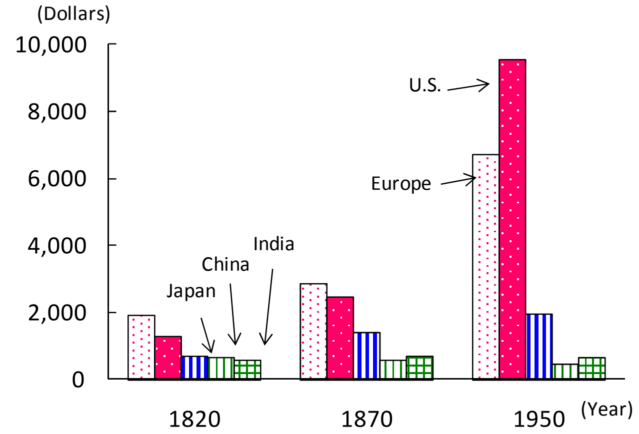
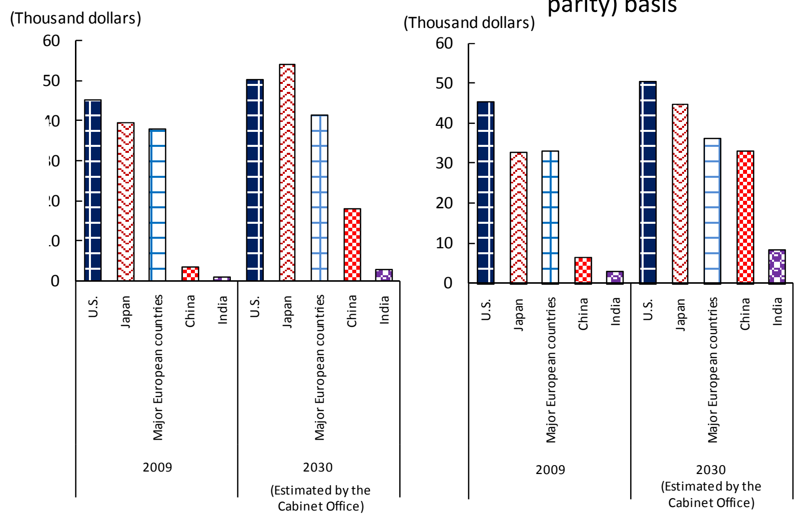


Figure 35 Projected Per Capita GDP: Increasing in China

(1) On a market rate basis (2) On a PPP (purchasing power parity) basis



- Growth in the presence of emerging countries can lead to an increase in risks while providing business chances through the creation of new investment targets and consumer markets.
  - Commodity demand expansion and price spikes: Export industries in resources-importing developed countries may suffer growing trading losses, fail to increase income, and fail to feel affluence despite GDP growth, unless they can pass raw materials price hikes on to their product prices through such measures as the improvement of their non-price competitiveness.
  - Political and social destabilization accompanying expanded income gaps in some emerging countries: Gravely affecting commodity prices and companies in developed countries.
  - Still-low income levels in emerging countries, and international cooperation: Per capita GDP is still at low levels in emerging countries despite their growing presence. The coexistence of many players with diversified income levels and values in the international community may make international cooperation more difficult .
  - Possible qualitative changes in the international financial system based on the U.S. dollar as the key currency
- Risks to increase through "Accelerated Globalization"
  - Unexpected international financial market fluctuations due to incorrect information: If incorrect or exaggerated information is reported, markets may excessively fluctuate to the great disadvantage of market participants. The enhancement of information transmission capacity and the diversification of information channels are needed to maintain confidence in governments and companies.
  - Possible outflow of excellent human resources: Excellent human resources move across national borders in search of places where they could flourish .
- Economic policy implications for developed countries including Japan: Building a resilient economy
  - While making efforts to promote policy cooperation in a bid to reduce risks in the international community, developed countries should enhance the resilience of their economic and financial systems to prevent any crisis from spilling over to themselves in the event of any shock from emerging risks and quickly overcome such shock with less damage.
    - Goods market: Energy strategies and food security based on the premise of commodity price hikes and trade structures to avoid trading losses
    - Financial and capital market: Macroprudence policies to ensure the soundness of financial systems, efforts to secure budget sustainability.
    - Labor market: An economic structure that avoids excessive dependence on export-oriented industries to prevent employment from being affected greatly by external demand fluctuations.
  - Policy authorities should be united to frequently check risks and share future risks on the premise of a multitude of risks in the world economy and to make persistent efforts to build a resilient economy that can resist any shock or drastic market change.

1. Recovery from the Global Financial Crisis

- Real economy: The pace of the world economy's recovery has been bipolarized. China and other emerging countries fear economic overheating, while developed countries are in a slower, scattered recovery (Figure 36).
  - Developed countries' recovery has come in a manner of taking advantage of emerging countries' high growth. Industrial countries have benefited from sharp growth in exports to emerging countries and their companies' activated business operations in emerging markets (Figure 37).
- Financial system: Recovering while being plagued with lingering aftershocks of the crisis.
  - Some European financial institutions still have high leverage ratios (Figure 38). Meanwhile, their earnings are at a low level.
  - In the United States, risks are still left involving mortgage-backed securities amid residential price falls, while loans have decreased on the back of deleveraging (Figure 39).

Figure 36 Real GDP Levels: Bipolarized

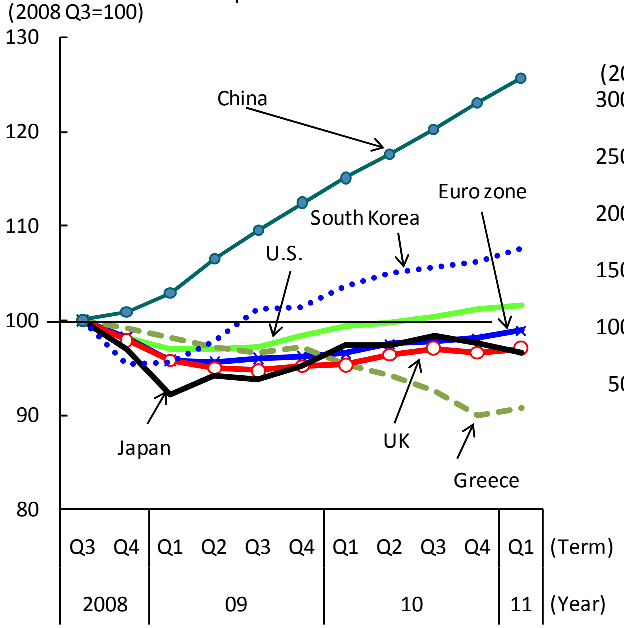


Figure 37 Auto Sales: Rapid growth in emerging countries

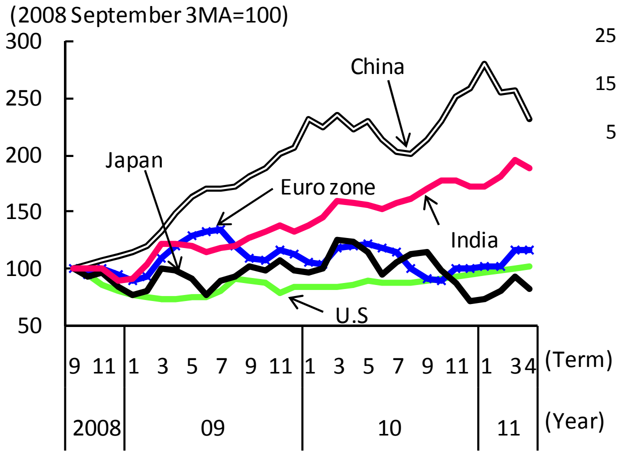


Figure 38 Trends in Leverage Ratios at U.S., European and British Financial Institutions: Still high in Europe

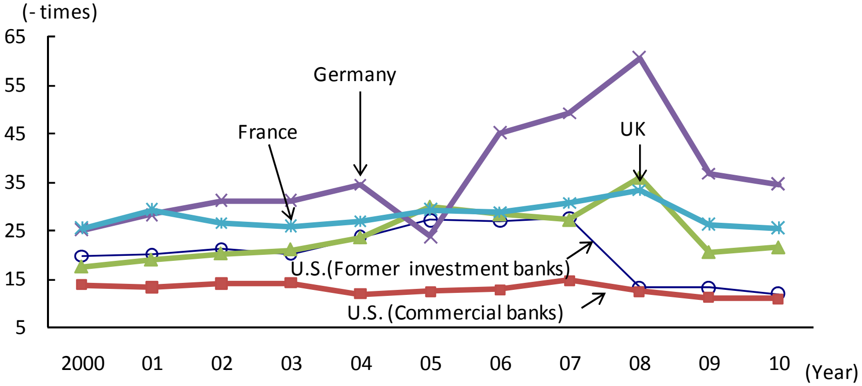
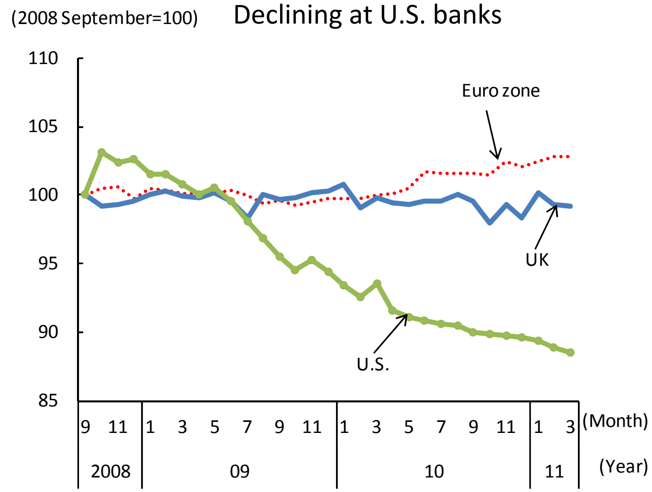


Figure 39 Outstanding Bank Loans: Declining at U.S. banks



2. Emergence of New Risk Factors

- <u>Price hikes due to crude oil spikes and monetary policy</u>
  - Oil prices have spiked. Factors behind oil price spikes include the expansion of emerging economies, developed countries' monetary easing, and growing tensions in the Middle East and North Africa (Figure 40). Grain prices have also soared.
  - Many emerging countries have implemented monetary tightening as prices have risen due to economic overheating fears and commodity price hikes. There is a risk that the greater-than-expected effects of monetary tightening could rapidly cool down domestic demand.
  - Developed countries see slow recovery with GDP gaps remaining wide. Their overall inflation has accelerated on the back of commodity price hikes, while their core inflation has remained low. The European Central Bank in April 2011 implemented its first interest rate increase since the global financial crisis. The Federal Reserve Board decided to continue Quantitative Easing 2 until the end of June. The European and U.S. central banks have thus adopted different policies, reflecting their difference over whether commodity price hikes could produce (1) the second-round effects through a rise in wages and the like or (2) economy-dampening effects.
    - ECB: The ECB has adopted overall inflation rates as its reference inflation rate under its mission to maintain price stability. It believes that a rise in the expected inflation rate could lead to future price hikes.
    - FRB: The FRB has a dual mandate to maximize employment and stabilize prices. It views a rise in the overall inflation rate amid commodity price hikes as temporary and gives priority to the core inflation rate.
- <u>Resurging sovereign risks and international financial markets</u>
  - Following Greece's receiving of financial support in May 2010, Ireland became subject to financial support in November 2010, and so did Portugal in May 2011. Government securities yields and sovereign CDS (Credit Default Swap) premiums have reached record highs.
  - Markets are still critical of European banks (Figure 41). This is because (1) European banks hold massive amounts of government securities issued by Southern European countries and could incur profit-affecting losses due to a fall in prices of these securities, (2) these banks have provided massive amounts of credit to Southern European countries and have faced the risk of expanded losses due to loan write-offs amid fundraising difficulties for corporate borrowers, and (3) these banks hold massive asset-backed securities, including residential mortgage-backed securities whose prices have slackened on the back of residential price falls (Figure 42).
  - Due to the global financial crisis, major industrial countries' sovereign debts have expanded to nearly $34 trillion. If private sector fund demand and investment demand in emerging countries increase due to economic recovery, markets may sort out government securities more toughly.

Figure 40 Countries Seeing Protest Demonstrations in 2011

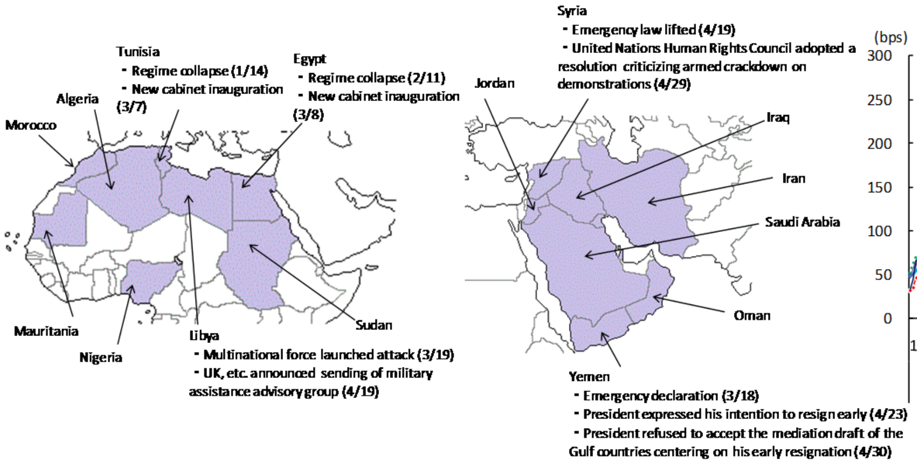


Figure 41 Major European Banks' CDS Premiums: Markets are skeptical

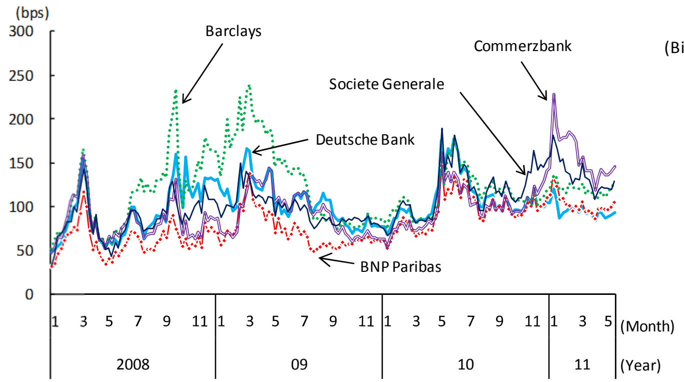
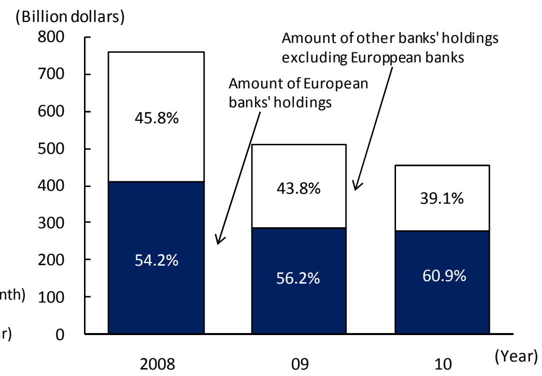


Figure 42 Volume of U.S. Private Sector ABS Issued and Their Breakdown by Holder: European banks hold abundant U.S. ABS issues



3. Effects of the Great East Japan Earthquake on the World Economy

- A decline in exports from Japan and supply chain disruptions amid the production suspension caused by the disaster have produced <u>such effects as a production cut through the reduction of plant operation days mainly in the auto sector in foreign countries</u>. Some overseas buyers had to shift to other suppliers or arrange substitute production for Japanese products, excluding special ones. In addition to Japanese firms, alternative suppliers of these products include many in other Asian countries such China.
  - Substitute production has been difficult for some high-tech auto components and electronic devices. Unexpectedly, the disaster highlighted Japanese manufacturers' superiority.
  - The U.S. industrial production index in April leveled off from the previous month as autos and automotive components declined 8.9% to make large negative contributions (Figure 43). April's annual auto production fell sharply to 7.86 million units from 8.98 million units in March.
- Some exports to Japan increased with others decreasing, while imports from Japan declined substantially.
  - Exports to Japan: Exports to Japan weakened due to a demand decline and Japan's domestic distribution disruptions just after the disaster. In and after late March, however, drinking water and other exports to Japan expanded substantially. Particularly, South Korea scored a substantial increase in exports to Japan in April. Taiwan also posted an increase in April after a temporary drop in March.
  - Imports from Japan: Growth in imports from Japan slowed substantially in March and April, mainly to China, South Korea and Taiwan, as many Japanese plants suspended production and shipments due to the disaster.
  - Over the medium term, exports to Japan are expected to increase for products for infrastructure reconstruction, housing, and other post-disaster restoration efforts. Japanese demand for LNG for thermal power plants is also expected to grow.
  - In Singapore, Taiwan, Thailand, and Malaysia, which all feature high ratios of exports to and imports from Japan to GDP, the stagnation of trade with Japan may have great impacts on their economies (Figure 44).
- While Asian emerging countries are concerned about a decline in direct investment from Japan, Japanese companies' reconsideration of major production plants and their global diversification of production bases can be expected to invigorate their direct overseas investment.

Figure 43 U.S. Industrial Production (auto output's contributions): Auto output made substantial negative contributions

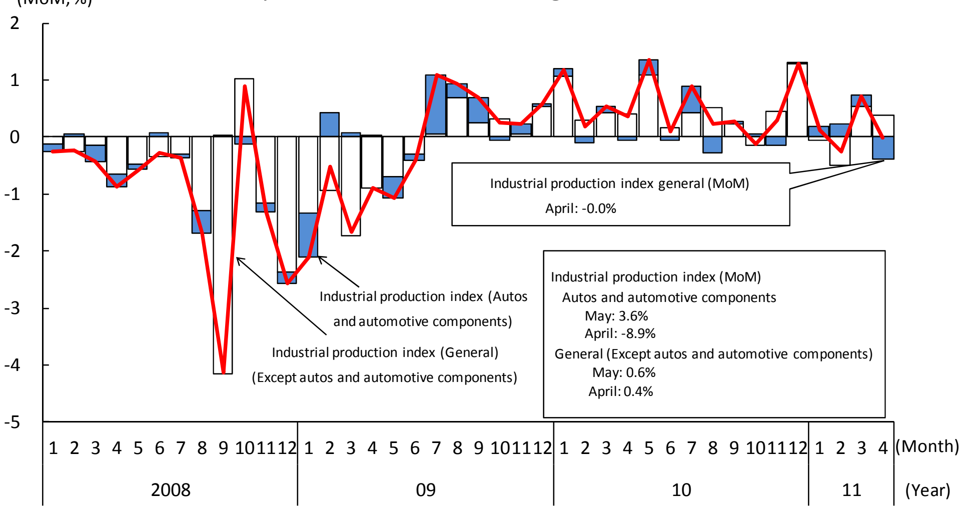
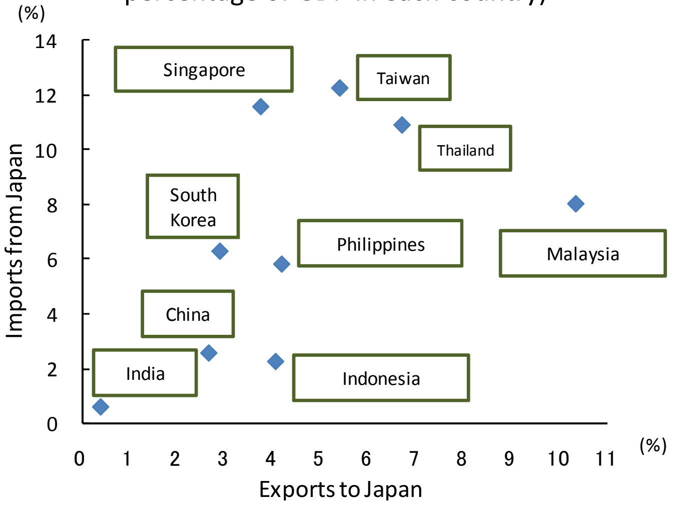


Figure 44 Japan-Asia Trade (2010, as a percentage of GDP in each country)



1-1 Trends in the Chinese Economy — The 12th 5-Year Development Plan and Challenges (1): Conversion to a Domestic Demand-driven Economy

- <u>The 12th 5-Year (2011–2015) Development Plan</u> adopted in March 2011 :
  - Efforts for sustainable growth: (1) The real economic growth target was lowered to 7.0% from 7.5% under the 11th plan. (2) Environmental protection targets were enhanced.
  - Efforts for improving people's lives: (1) Reduction of income gaps, (2) development of social security systems, (3) expansion of housing supply, etc.
- <u>Conversion into a domestic demand-driven economy – Consumption structure changes and underlying income gaps</u>:
  - Consumption's share of GDP is low, following a downward trend. Particularly, rural regions' consumption share has declined conspicuously.
  - Consumption structure: Per capita household consumption spending has more than doubled in the past decade both in urban and rural regions. In urban regions, foods' share of consumption has declined while the share for transportation and communication spending expanded sharply. Automobiles, computers, and mobile phones have diffused rapidly (Figure 45). High- and middle-income groups have contributed to expanding consumption (Figure 46). In rural regions as well, foods' share of consumption has declined sharply.
  - Income levels: Per-household disposable income in urban regions has increased 2.5-fold in the past decade (Figure 47). Income growth has been faster for higher-income groups, contributing to the expanding income gaps. In rural regions, income has increased for all groups. However, income levels in rural regions are still lower than in urban regions. In addition to agricultural income, wage income has followed an upward trend (Figure 48).

Figure 45 Diffusion of Durable Consumer Goods among Urban Households: Rapid diffusion
(By income group, number for 100 households)

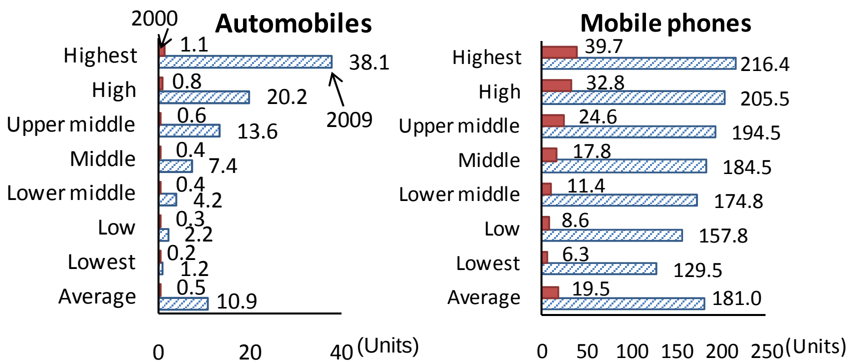


Figure 47 Per-household Disposal Income by Income Group (Urban Regions):
Growing income gaps

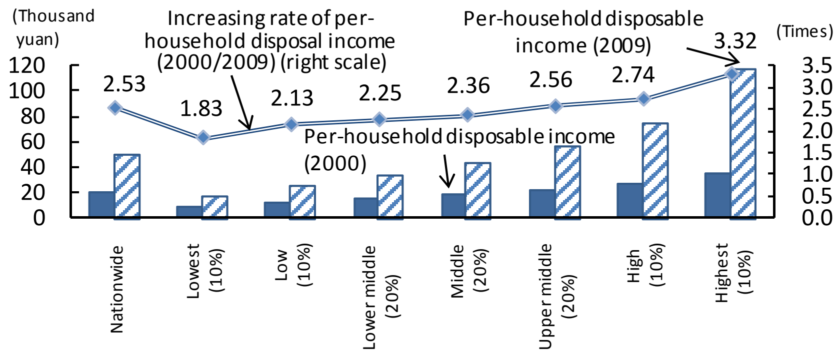


Figure 46 Urban Household Consumption Spending by Income Group:
High- and middle-income groups have contributed to expanding spending

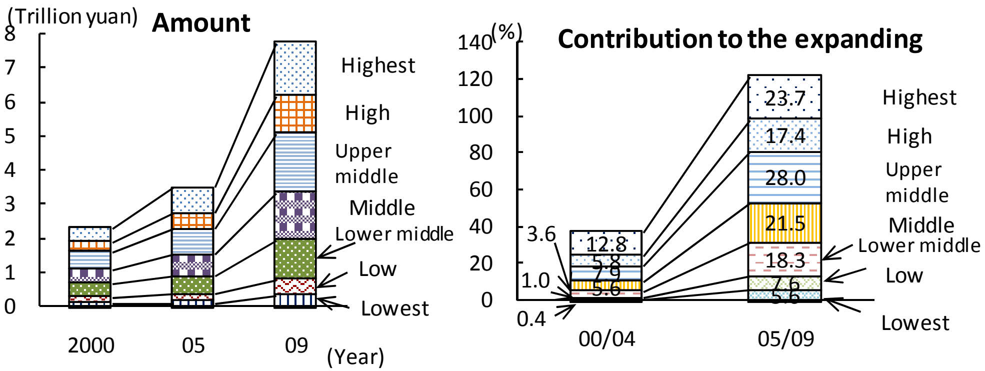


Figure 48 Breakdown of Rural Per-capita Net Income:
Rising wage income