1-2. The Chinese Economy's Challenges (2): Two Problems Facing the Labor Market

- Employment difficulties for university graduates:
  - University enrollment limits have been raised substantially to allow almost all enrollment applicants to enroll. The number of university graduates has increased rapidly nationwide. In 2010, the number reached 5.75 million, increasing nine-fold from two decades ago. As a result, employment difficulties have emerged for university graduates (Figure 49). Contributing to the difficulties are insufficient vocational training at universities, and university graduates' hopes for better job locations and working conditions.
- Shortages of factory workers from farming villages: People have increasingly flowed from rural regions into urban regions (Figure 50). But there are shortages of low-wage migrant factory workers from rural regions, mainly in coastal cities.
  - Background: (1) The number of births for the young generation has been low. (2) Workers from rural regions are not eligible for the same healthcare/welfare and education benefits as urban residents (family registration problems). (3) Employment has increased with wages rising in inland regions (Figure 51). (4) More young people undergo higher education.
  - China might have hit "the Lewisian turning point", where surplus labor is depleted with wages beginning to rise after a labor shift from agriculture to manufacturing. Japan reportedly hit the turning point in the 1960s before gaps between regions narrowed (Figure 52).
  - Challenges: (1) Family registration system reforms and vocational training are needed to improve treatments for rural registered residents. Agriculture productivity improvement is needed to facilitate a labor shift to urban regions. (2) Labor-intensive industries should develop into high value-added industries.

Figure 49 Trends in Ratios of Job Seekers to Offers by Educational Qualification:
A lower ratio for university graduates

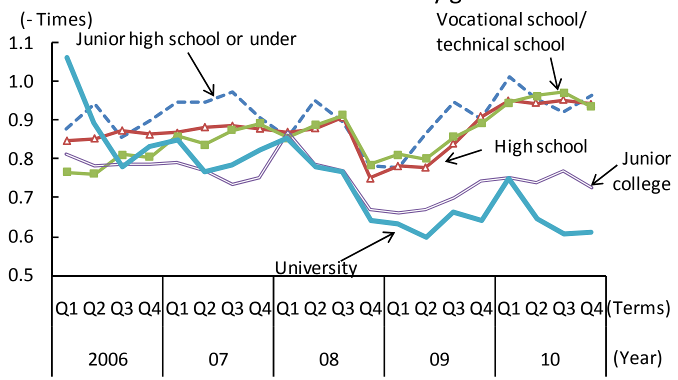


Figure 50 Trends in Population and Registered Residents in Urban and Rural Regions: Rural population has increasingly flowed into urban regions

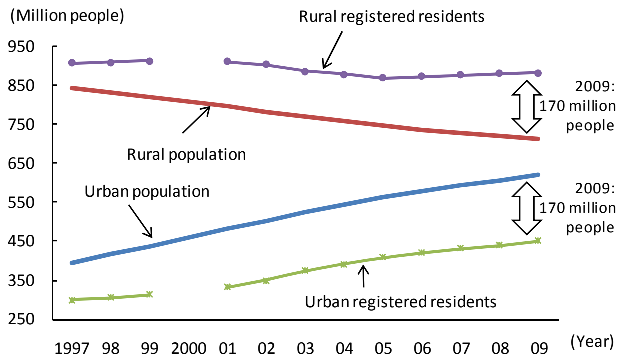
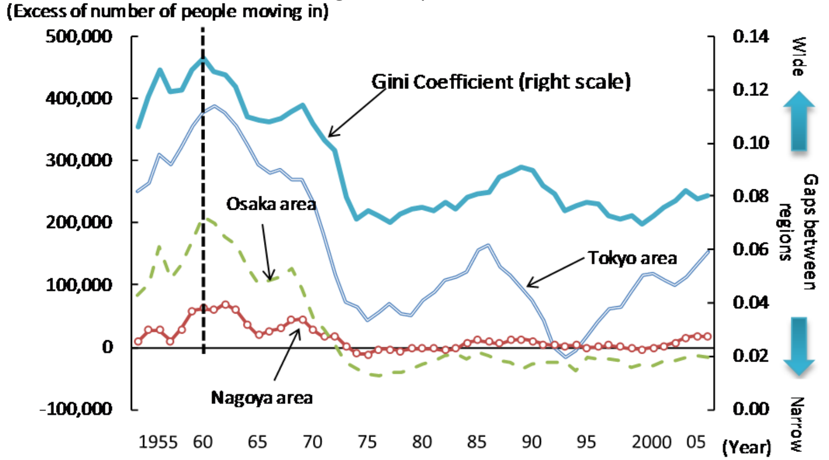


Figure 51 Comparison of Regional Wages for Factory Workers from Rural Regions: Wages are rising in inland regions as well

		Nationwide	Eastern area	Middle area	Western area
2008	(Monthly amount, yuan)	1,340	1,352	1,275	1,273
2009		1,417	1,422	1,350	1,378
Increasing rate (%)		5.7	5.2	5.9	8.2

Figure 52 A Population Shift to Metropolitan Regions in Japan and Trends of the Gini Coefficient for Per capita Prefectural Income: Falling after a peak around 1961



2. Indian Economic Structure

- <u>Industrial and employment structure changes:</u>
  - The industrial structure has dramatically changed. Over the past two decades, the primary industry's share has declined with the tertiary industry's share expanding. Within the tertiary industry, the real estate, business services, and financial and insurance sectors have expanded their respective shares. Meanwhile, <u>the employment structure has shown no major change since 1990. India has not seen the economic development path often observed in emerging countries, where surplus labor emerges on the back of improvements in agricultural productivity and shifts to secondary and tertiary industries</u> (Figure 53).
- Comparison with China:
  - India's per capita GDP was similar to the Chinese level in 1990 but stood at less than one-third of the Chinese level in 2009 (Figure 54). Inter-region income gaps have narrowed in China but widened in India (Figure 55).
  - Factors: (1) India started economic reforms to trigger economic growth later than China. (2) Indian education levels are lower (Figure 56). (3) India has lagged behind China in developing infrastructure. (4) Agricultural productivity has remained low, impeding a labor shift.

Figure 53 Economic Structure Changes (Share Changes) in Asian Countries:
India's employment structure has changed only a little

(1) Industrial Structure (on a nominal GDP basis)
(1990–2009, 1970–1990 for Japan)

(2) Employment Structure
(1993–2007, 1970–1990 for Japan)

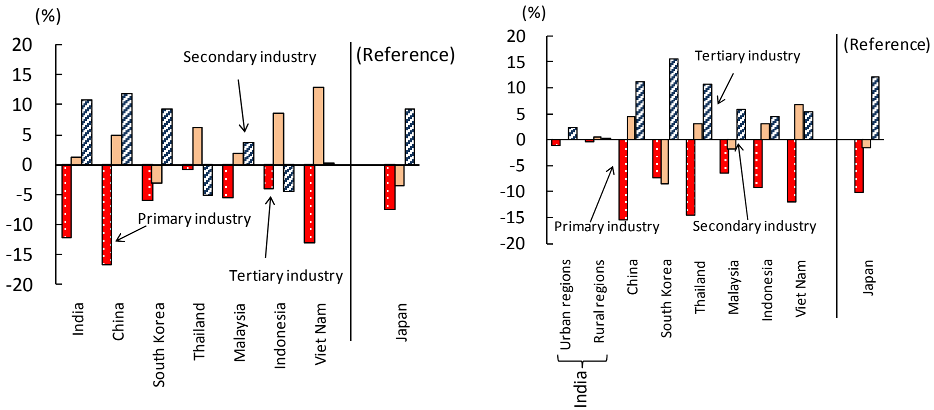


Figure 54 Indian and Chinese Per Capita GDP Changes: Large India-China gaps

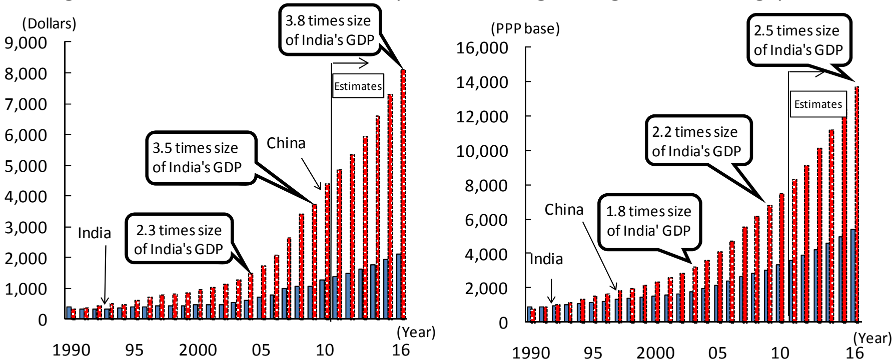


Figure 55 Inter-region Per Capita Nominal GDP Gaps in India and China:
Gaps have widened in India

(1) India　　(2) China

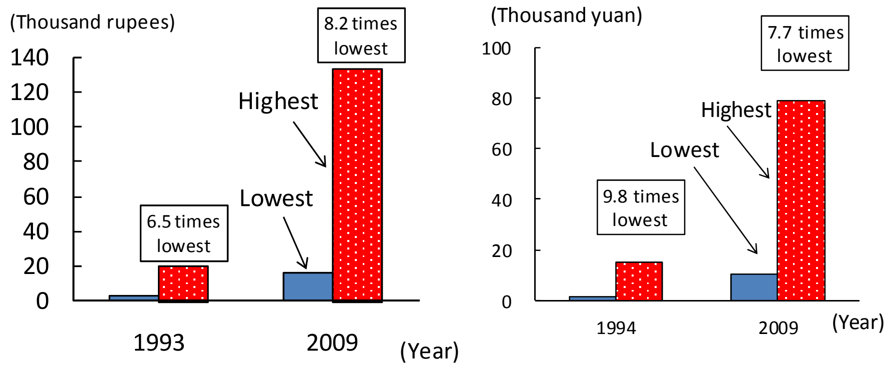
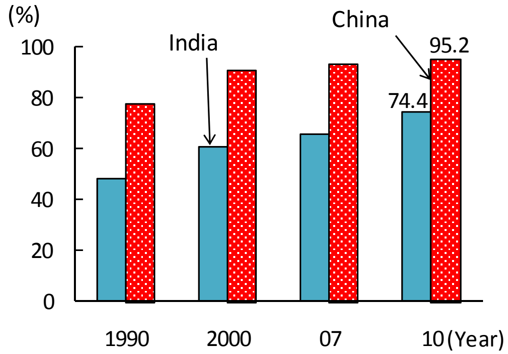


Figure 56 Trends of Indian and Chinese Literacy Rates:
Lower rates in India



1. Overview of the U.S. Economy — Bipolarization of Consumption, High Unemployment and Trade Structure Changes —

- Bipolarization of consumption: The high-income group’s consumption has sharply expanded, while the low-income group’s spending has slackened. The high-income group’s consumption is sensitive to stock price fluctuations, while the low-income group’s consumption is susceptible to energy and other price fluctuations.
  - The top 20% of income earners account for about 40% of consumption. The top 5% of asset holders own about 80% of equity shares (Figure 57). Stock price hikes have stimulated the high-income group’s consumption through the asset effect, leading to relatively high growth in luxury-product sales and department-store sales.
  - Meanwhile, the low-income group has held down consumption in view of recent gasoline and food price hikes (Figure 58). Food stamp benefit recipients account for a record 14.2% of the total population.
- Employment:
  - Payroll number: Payroll number has continued to increase, but the pace of increase is slower than during past economic recovery periods (Figure 59).
    - Employment growth has accelerated in the manufacturing and specialized-service sectors. Meanwhile, mainly state and municipal governments have continued employment adjustment.
  - Unemployment rate: The rate has fallen slightly due to the accelerated expansion of employment. But its current level of 9% is still higher than the structural rate of 5–6%.
  - Employment sentiment has improved and employment mismatches have indicated signs of improvement.
- Trade: Exports to emerging countries have expanded. The United States’ share of total exports to China, India, and Brazil rose from 4% in 2000 to 12% in 2010. Particularly, China has become the largest export destination among foreign countries other than NAFTA members (Figure 60).

Figure 57 U.S. Consumption Structure:
Trends in the high-income group are influential

(1) Consumption shares for five income groups

(2)Breakdown of stock holdings by investor group

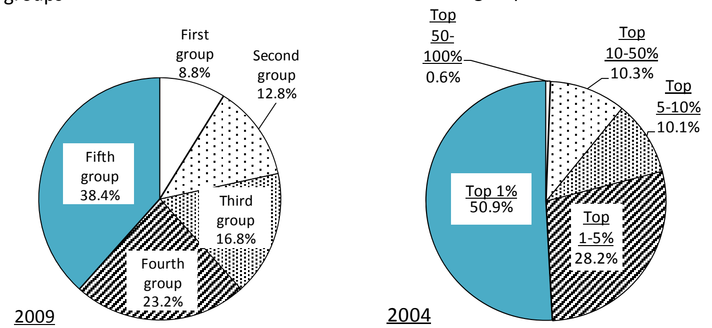


Figure 58 Trends of Low-Income Group Consumption: Energy price hikes have greater influence on low-income group consumption

(1) Proportion of gasoline cost to disposable income

(2) Trends in gasoline prices

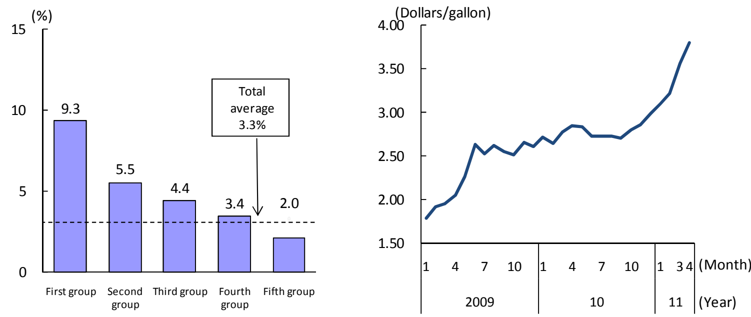


Figure 59 Non-farm Payrolls during Past Recovery Periods:
Employment recovery is slower than during past recovery periods

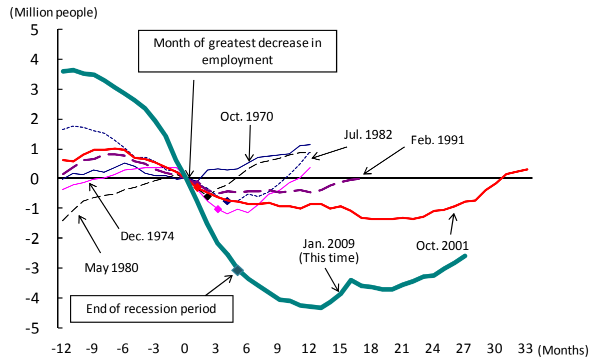
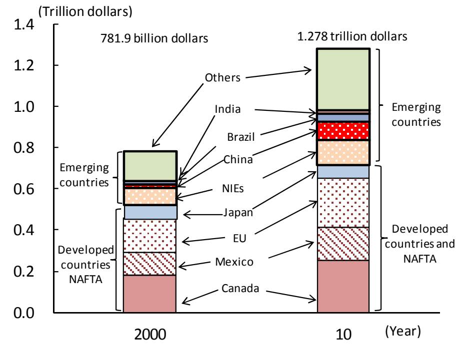


Figure 60 Trends in Export Destination Shares:
The U.S. share of exports to emerging countries has expanded



2. Aftereffects of the Global Financial Crisis — Slack Residential Markets, Financial System and Local Finance —

- Slack residential markets: Housing starts and sales have remained slack, with residential prices resuming a downward trend.
  - Background: While mortgage rates and residential prices have remained low, the anticipation of lower residential prices have prevented them from stimulating demand. On the supply side, the existing-home market inventory has remained as high as 3.5 million houses and has resumed an increase (Figure 61). A so-called “shadow inventory” also exists.
- Financial system: Further small and medium-sized financial institutions have been going bankrupt. In 2010, 157 banks went bankrupt, exceeding the 2009 level (Figure 64). The bad-loan share has remained high for commercial mortgages, with vacancy rates rising.
- State and municipal finance: Despite improvements, economic recovery is still patchy, with some local governments plunging into revenue shortages. In a bid to keep their operating budgets balanced, local governments have reduced healthcare/education services and dismissed employees in order to cut spending.
  - Municipal bond market: Municipal bond issuances have slackened on the back of the deterioration of fiscal and economic conditions. Investors have been withdrawing from municipal bond funds (Figure 63).
    - Municipal bond yields have risen again since September 2010. Their spreads with Treasury yields have widened (Figure 64).
    - If fundraising through municipal bond issuances becomes difficult, (1) spending cuts may push down local economies, and (2) demand from households that own great amounts of municipal bonds may decline.

Figure 61 Existing-home Market Trends: Inventory at high levels

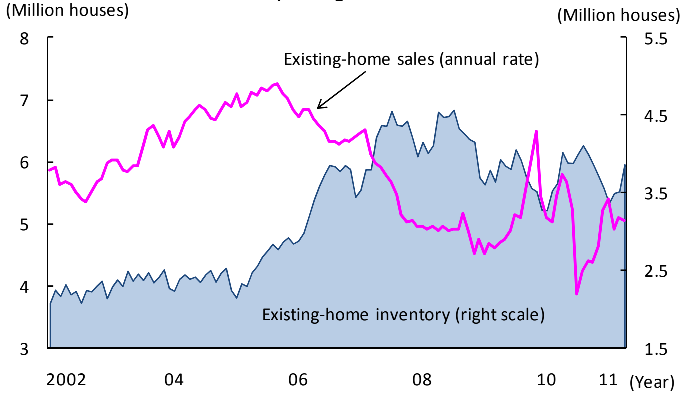
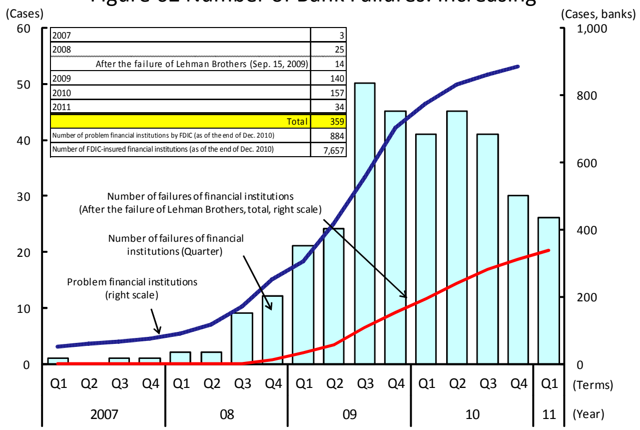


Figure 62 Number of Bank Failures: Increasing



2007	3
2008	25
After the failure of Lehman Brothers (Sep. 15, 2009)	14
2009	140
2010	157
2011	34
Total	359
Number of problem financial institutions by FDIC (as of the end of Dec. 2010)	884
Number of FDIC-insured financial institutions (as of the end of Dec. 2010)	7,657

Figure 63 Monthly Net New Cash Flow of Municipal Bond Funds: Investors are withdrawing

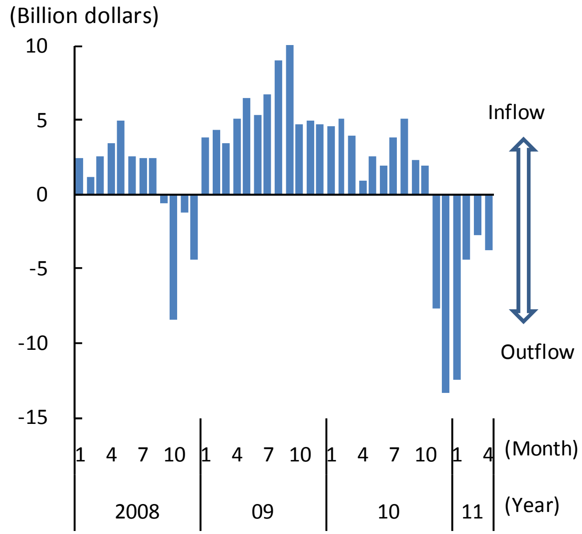
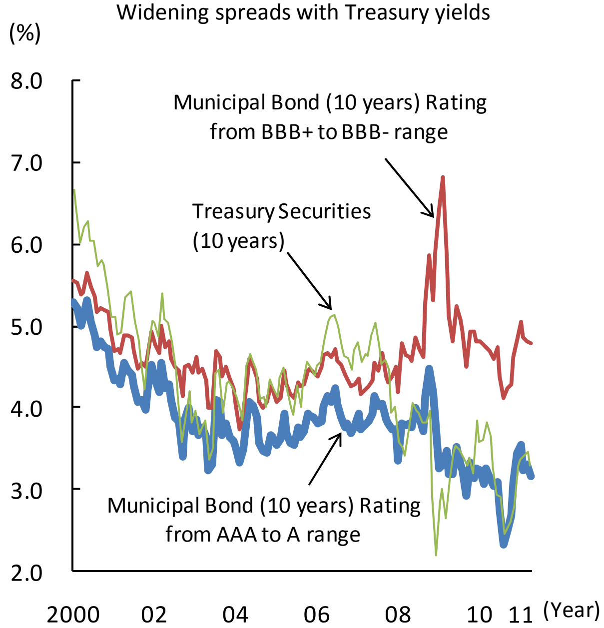


Figure 64 Trends of Municipal Bond Yields: Widening spreads with Treasury yields



3. Fiscal and Monetary Policy Trends

- Unusually low interest rates and additional quantitative easing (QE2):
  - The federal-funds rate has remained in the 0–0.25% range for two years and a half since December 2008. The FRB has continued to note that "economic conditions are likely to warrant exceptionally low levels for the federal funds rate for an extended period."
  - In response to an economic recovery slowdown from the spring of 2010, the FRB implemented the additional quantitative easing (QE2) policy to purchase $600 billion in medium to long-term Treasury securities between November 2010 and June 2011. As a result, the FRB's balance sheet has almost tripled from before the global financial crisis (Figure 65).
- Effects of QE2: (1) Stock price hikes and wealth effect to push up consumption (Figure 66), (2) a decline in corporate bond spreads (Figure 67) and an increase in corporate bond issues, (3) a rise in inflation expectations and receding deflation fears (Figure 68), but (4) credit creation have been limited.
- Future focuses of attention :
  - Fiscal policy: As federal budget deficits and debt outstanding are huge, an intensifying confrontation between ruling and opposition parties has made the future course of the U.S. economy uncertain ahead of the 2012 presidential election. Debt outstanding is expected to reach the statutory limit on August 2. Will any agreement be reached to raise the debt limit by the date?
  - Monetary policy: An exit strategy after the QE2 completion in June (including what to do with the FRB balance sheet and the policy interest rate)

Figure 65 FRB Balance Sheet: Tripling

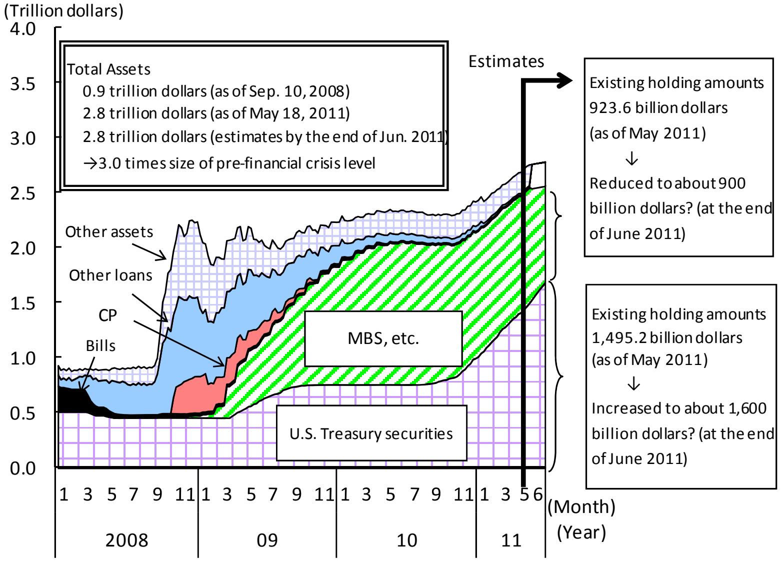


Figure 66 Trends of Stock Prices: Stock price hikes

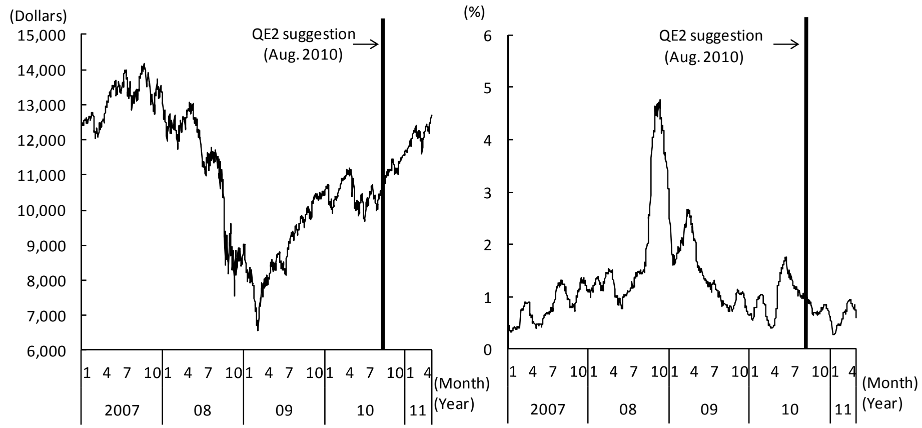


Figure 67 Corporate Bonds Yield Spreads: Narrowing

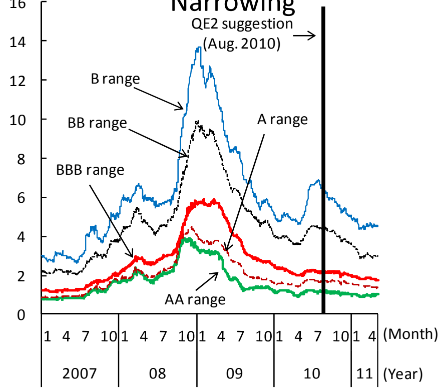
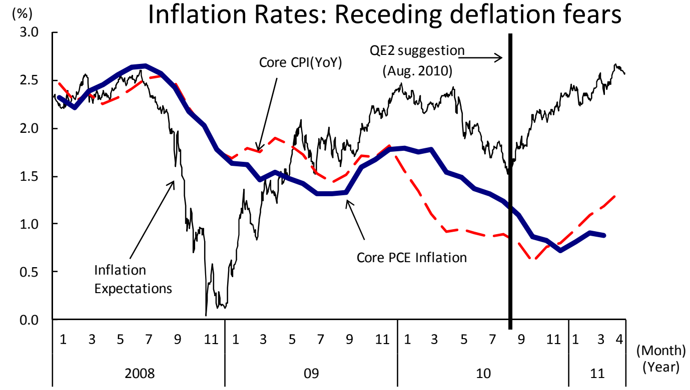


Figure 68 Trends of Expected and Actual Inflation Rates: Receding deflation fears



1. Present European Economic Situation — Growth-Driving Trade Structure Changes —

- Economic performances are patchy and bipolarized.
- Germany-driven EU exports: In the 2000s, the strong growth of German exports continued persistently, but French and British exports were sluggish (Figure 69).
- Production networks created between neighboring countries within the EU area: (1) Germany and France trade intermediate goods with Central and East European countries. (2) Germany-France intermediate goods trade has increased. (3) Belgium and Luxembourg provide Germany and France with intermediate goods (Figure 70).
- Exports expanding on growing emerging-market demand: Among European final goods exports to China, the exports of French aircraft have expanded. Germany and the United Kingdom have increased car exports to China as income levels there have risen.

Figure 69 Major European Countries' Exports by Destination: The strong growth in German exports has persistently continued

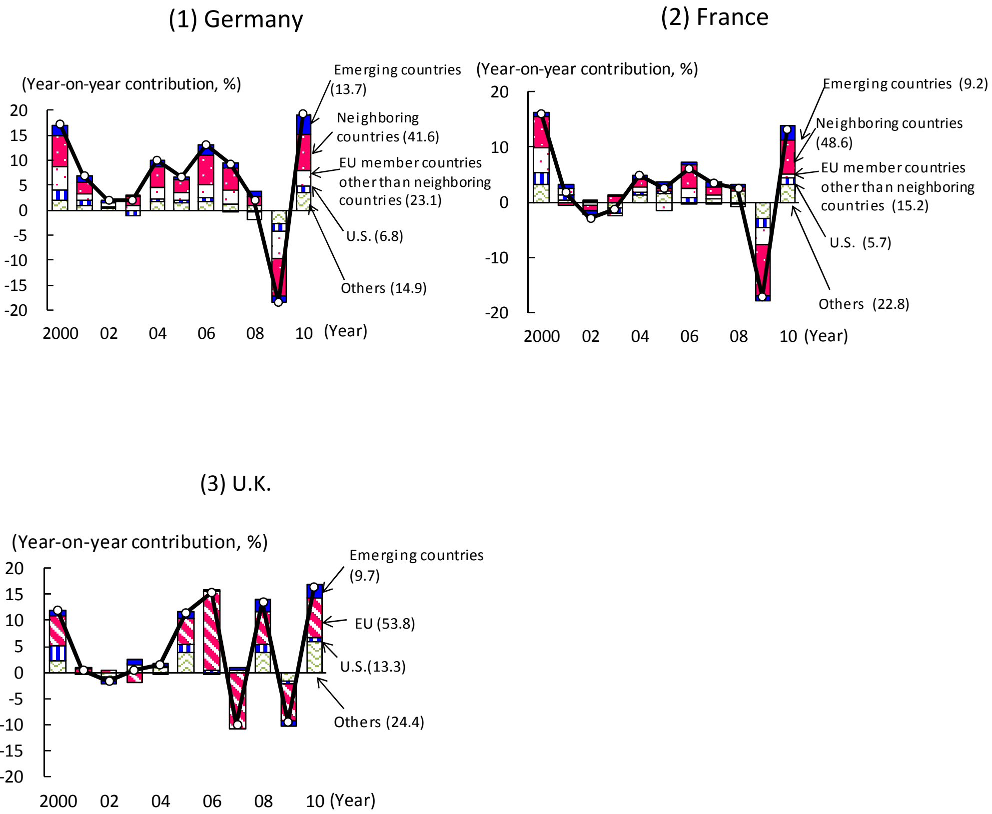
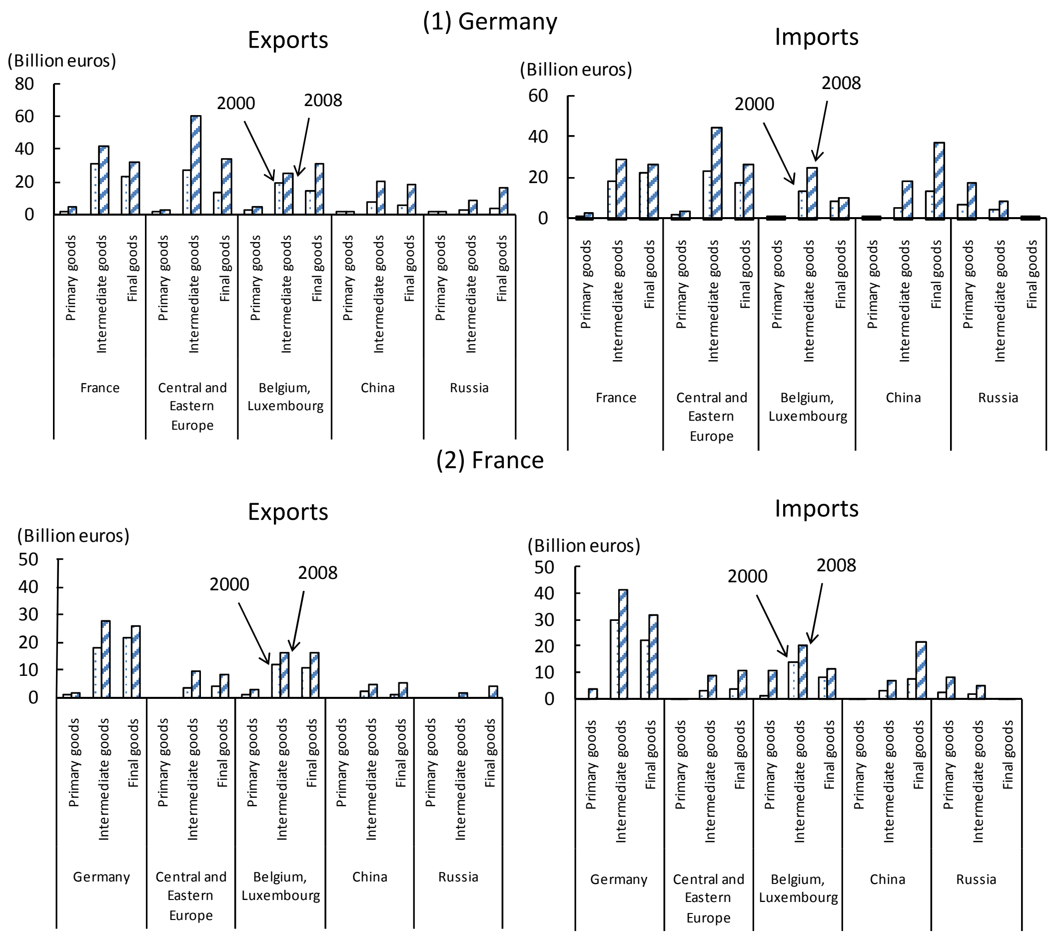


Figure 70 German and French Trade in Intermediate and Final Goods: Growing intermediate goods trade with neighboring countries



2-1 Fiscal and Monetary Policy Trends (1) — Resurging Sovereign Risks in Southern European Countries and Their Impact on Financial Systems —

- Amid concerns over fiscal conditions in some countries, government bond yield spreads and CDS (Credit Default Swap) premiums have soared sharply.
  - Greece: Growing debt restructuring fears have led government bond yields to soar. Sovereign CDS premiums have hit a record high. Despite the announcement of the additional budget austerity plan in April 2011, market fears have been lingering.
  - Ireland: In November 2010, the European Commission, the Eurogroup, and the International Monetary Fund agreed on financial aid for Ireland (worth 85 billion euros)
  - Portugal: In May 2011, the EU and IMF agreed on financial aid for Portugal (worth 78 billion euros).
- Given the possibility of private-sector involvement in government debt restructuring from July 2013, credit-rating agencies have downgraded Greek and other sovereign credit ratings one after another (Figure 71).
- Resurging sovereign risks are feared to affect financial systems through deterioration or failure of financial institutions with a huge loan exposure to Southern European countries.
  - European countries hold 60% of South European countries' government securities (Figure 72). German and French financial institutions have had a large share of loans to Southern European countries.
  - The ECB's outstanding liquidity supply to Southern European financial institutions has increased substantially (Figure 73). So-called "zombie banks" may exist. Bank stress test results will be released in mid-June.

Figure 71 Trends in Greek, Irish, and Portuguese Sovereign Credit Ratings: Downgraded one after another

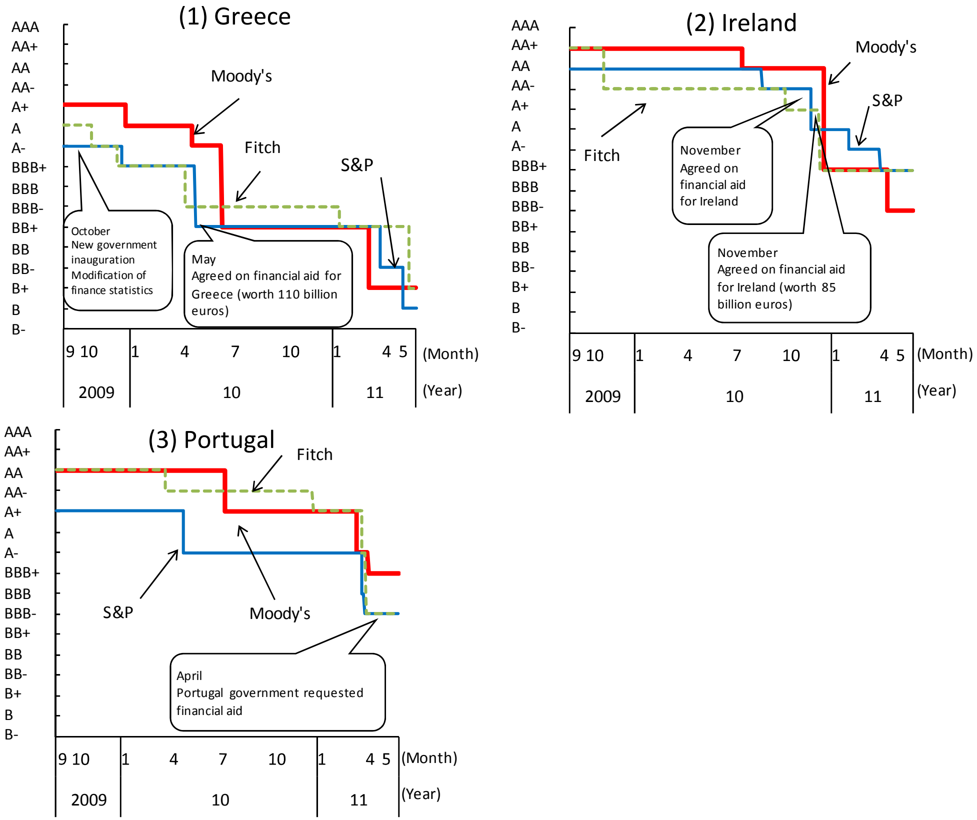


Figure 72 Holdings of South European Countries' Government Securities: More than 60% held in Europe

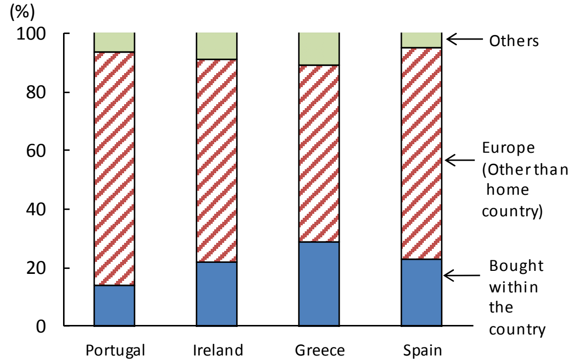
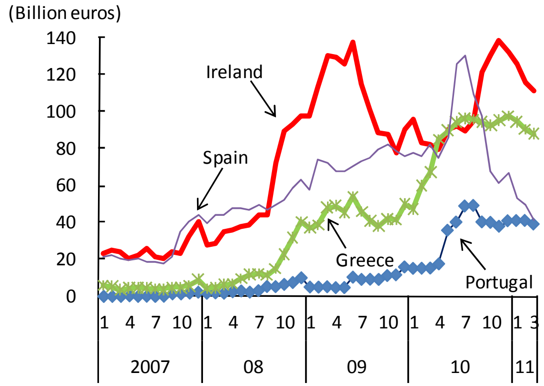


Figure 73 ECB's Outstanding Liquidity Supply: Sharp growth

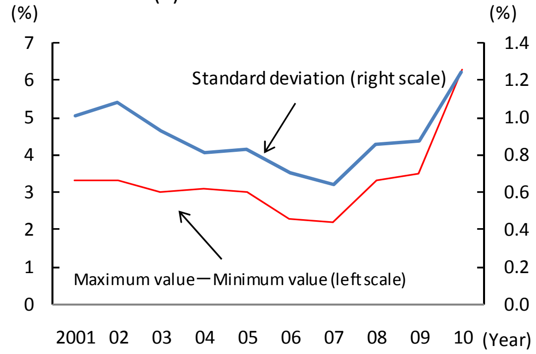


2-2 Fiscal and Monetary Policy Trends (2) — Increasingly Varied Economic Situations —

- In the euro area, where a monetary union has been achieved, there are constraints to each country's flexible monetary policy meeting national conditions. It is desirable for euro area countries to have similar economic situations to stabilize the single European currency of the euro.
- A comparison of present situations with the economic convergence criteria for the Economic Monetary Union indicates that the euro participating countries' economic situations have not converged but have been more varied (Figure 74).
- Most of the present euro participating countries have yet to meet the convergence criteria. Their situations are more varied in terms of economic indicators than in 1997, when their situations were assessed for euro participation (Figure 75).
- There is concern that it could be even more difficult for the ECB to conduct any unitary monetary policy.

Figure 74 Trends in Euro Participating Countries' Varied Economic Situations: Increasingly varied

(1) Consumer Price Index



(2) Long-term Interest Rates

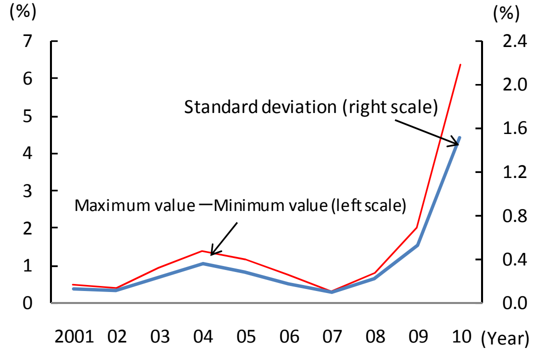
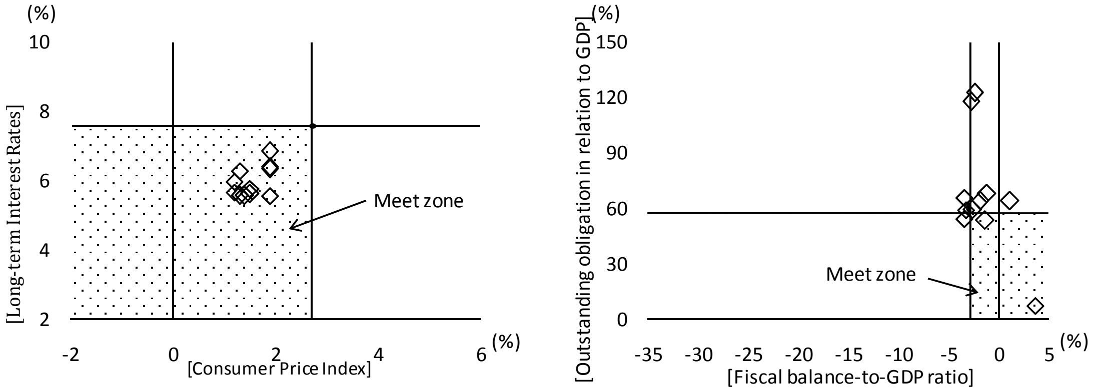
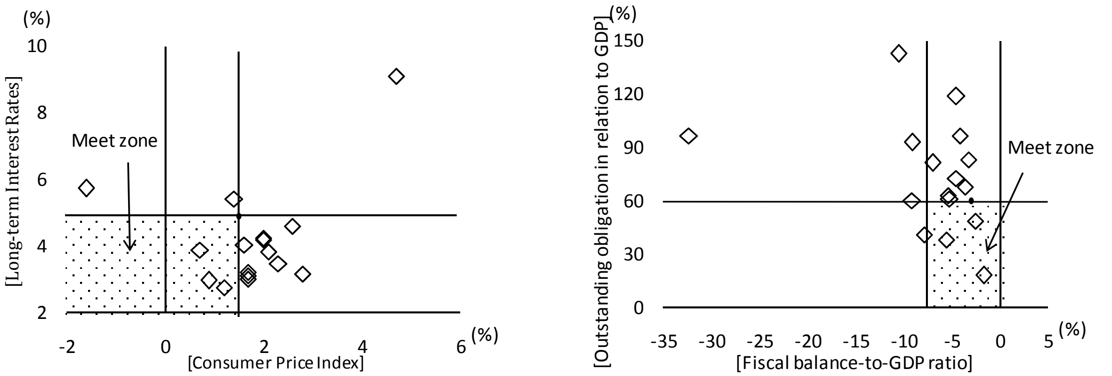


Figure 75 Decision on Whether Euro Participating Countries Meet Economic Convergence Criteria for Euro Participation: Many countries fail to meet the criteria at present

(1) Year of Decision to Introduce the Euro (1997)



(2) Present (2010)



- U.S.: Recovery will continue.
  - Forecast: The real economic growth rate for 2011 is projected at around 2.5%.
    - Consumption growth will grow more autonomous on the back of improvements in the employment environment. Business investment will moderately recover as corporate earnings improve.
    - But a recovery pace will be moderate due to crude oil price spikes, a high unemployment rate, and severe federal and local government budget conditions.
  - Risks: Downside risks, though weaker than they were six months ago, are more dominant than upside risks.
    - Downside risks: (1) Further spikes in commodity prices, (2) the unemployment rate remaining at a high level, (3) further declines in residential prices, (4) regional economic slowdown as state and municipal fiscal conditions deteriorate, (5) financial deterioration for small and medium-sized financial institutions
    - Upside risks: (1) Asset price hikes, (2) growing exports, (3) substantial easing of credit crunches
- Europe: While recovery will continue, European countries will be further bipolarized in terms of economic performances.
  - Forecast: The real economic growth rate for 2011 is projected at around 2.0%.
    - While exports and production will continue growing, mainly in Germany, business investment and consumption will be robust. The entire European economy will continue recovering.
    - Given (1) that Southern European countries are required to implement large-scale fiscal reconstruction measures, (2) that such countries as the United Kingdom and Spain are still plagued with burst bubble effects, (3) that sovereign risks are growing in Southern European countries, and (4) that although the effects of the German economic recovery on Southern European countries through intra-regional trade are limited, European countries may be further bipolarized in terms of economic performance.
  - Risks: Downside risks are still dominant. Particularly, resurging sovereign risks is a serious risk factor.
    - Downside risks: (1) Re-expansion of financial system fears on resurging sovereign risks, (2) acceleration of price hikes, (3) stagnant recovery after the burst of housing bubbles in the United Kingdom and Spain, (4) export falls as the U.S. and Asian economies decelerate, (5) deterioration of the employment situation more than expected.
    - Upside risks: Expansion of exports on a greater-than-expected world economic recovery

- <u>Asia: Economic expansion or recovery will continue.</u>
  - Forecast: Although consumer and real estate price hikes must be closely watched, Asian economies are expected to continue expanding or recovering if they are under appropriate economic policy management. (International organizations have projected China to grow by 9–10% in 2011 and India to grow by 7–8%. These projections are roughly reasonable.)
    - Macroeconomic effects of the Great East Japan Earthquake on the Asian economy will be limited: Production cuts have been seen in parts of the automotive and other industries. Meanwhile, moves emerged to increase production of products replacing Japanese goods. Post-disaster reconstruction demand is expected.
  - Risks: Overall, downside risks are balanced with upside risks.
    - Downside risks: (1) Chinese real estate price hikes and the impact of relevant enhanced monetary tightening on domestic demand, (2) acceleration of price hikes, (3) excessive money inflow, (4) greater-than-expected effects of the Great East Japan Earthquake, (5) export slowdown on stagnant economic recovery in developed countries
    - Upside risks: Asset price hikes backed by money inflow
- <u>World economy: Recovery will continue</u>
  - Forecast: The world economy is projected to post a real economic growth rate in the 3.0–3.5% range (on a market rate basis) in 2011.
  - Risks: Downside risks are more dominant than upside risks. Attention must be paid to various underlying risks regarding global imbalances as reviewed in Chapter 1.
    - Downside risks: (1) Re-expansion of financial system fears on resurging sovereign risks in Europe, (2) further commodity price hikes, (3) excessive money inflow into emerging countries and burst of bubbles in these countries, (4) greater-than-expected effects of the Great East Japan Earthquake
    - Upside risks: Asset price hikes