

World Economic Trends, Spring 2003, no.3

Published on April 26 by the Cabinet Office

“World Economic Trends” is a biannual report in Japanese issued by the Cabinet Office, first published in May 2002. It aims to examine implications for economic and fiscal policy in Japan through the study of recent policy developments around the globe.

(summary)

The spring report focuses on three topics: deflation in the economies of Asia, the experiences of industrial revitalization in some Nordic and Asian countries, and the world economic outlook for 2003 and 2004.

--Deflation in Asian Economies

The Japanese economy is undergoing moderate deflation that is detrimental to economic growth. In Asia, a deflationary trend is also found in China, Hong Kong, Taiwan, and Singapore (table 1). Chapter 1 investigated causes of deflation with an emphasis on the effects of inexpensive Chinese products. Chinese exports have been growing rapidly since the early 1990s. As a result, the share of Chinese goods in each market rose significantly (Table 2). This rapid increase has triggered an argument that China is exporting deflation to surrounding economies. In particular, this issue has been extensively debated in Japan.

Table 1 CPI Inflation in Major Countries and Economies

Some Asian countries and economies are on a deflationary trend since the second half of 90's.

	80's	90's		97	98	99	00	01	02	03 (estimate)
		first	second							
Japan	2.1	1.4	0.3	1.8	0.6	-0.3	-0.7	-0.7	-0.9	-0.7
China	10.5	13.1	1.9	2.8	-0.8	-1.4	0.4	0.7	-0.8	0.2
Hong Kong	-	9.2	1.5	5.8	2.9	-4.0	-3.7	-1.6	-3.0	-1.6
Taiwan	3.1	3.8	1.4	0.9	1.7	0.2	1.3	0.0	-0.2	0.3
Singapore	2.3	2.6	0.9	2.0	-0.3	0.0	1.4	1.0	-0.4	0.9
Korea	6.4	6.2	4.0	4.4	7.5	0.8	2.3	4.1	2.7	3.5
Indonesia	8.6	8.9	19.3	6.7	57.6	20.5	3.7	11.5	11.9	9.0
Thailand	4.4	4.8	4.3	5.6	8.1	0.3	1.6	1.7	0.6	1.7
Malaysia	3.3	4.0	3.1	2.7	5.3	2.7	1.5	1.4	1.8	2.5
Philippines	13.7	10.1	7.1	5.9	9.7	6.6	4.3	6.1	3.1	4.0
U.S.	4.7	3.1	2.5	2.3	1.6	2.2	3.4	2.8	1.6	2.3
Germany	2.6	3.1	1.4	1.9	0.9	0.6	1.9	2.5	1.3	1.0

(Source): I M F "International Financial Statistics", "World Economic Outlook" (Apr.2003)

Table 2 Share of Chinese goods

(%)

	1992	2001
Japan	0.4	1.4
Taiwan	0.4	2.1
Hong Kong	44.8	53.4
Singapore	4.5	8.5
U.S.	0.4	1.1
Germany	0.4	1.0
Korea	1.2	3.1

(Note) Share of Chinese goods = Imports from China / GDP

To quantify the causes of deflation, the Cabinet Office made the estimation with the OLS (ordinary least squares) method on changes in CPI (consumer price index) of each economy under a common theoretical framework (the expectation-augmented Phillips curve). The regression was run on a quarterly basis over seven economies: Japan, Taiwan, Hong Kong, Singapore, U.S., Germany, and Korea (Table 3).

Table 3 Explaining factors of quarterly changes in CPI

() : t-statistics

country/economy estimated period	Constant	GDP Gap	Monetary Base	Expected Inflation Rate	Exchange Rate	Trend	Dummy	R ² D.W.
Japan [91Q1 ~ 02Q4]	0.239 (1.297)	0.041 (1.263)	0.059 (2.111)	0.220 (1.067)	0.010 (1.355)	-0.011 (-1.708)	1.319 (4.138)	0.562 2.986
Taiwan [91Q3 ~ 02Q4]	1.059 (3.918)	0.020 (0.376)	0.011 (0.380)	0.057 (0.406)	0.046 (1.160)	-0.025 (-2.890)	-	0.225 2.601
Hong Kong [92Q4 ~ 02Q4]	1.133 (2.447)	0.168 (6.009)	0.017 (1.138)	0.329 (2.298)	-	-0.035 (-2.175)	-	0.872 2.285
Singapore [91Q3 ~ 02Q4]	0.711 (7.142)	0.016 (0.742)	0.010 (1.045)	-	-	-0.016 (-4.545)	-	0.302 1.266
U.S. [91Q2 ~ 02Q4]	0.564 (3.568)	0.040 (1.502)	0.099 (2.985)	0.108 (0.904)	-0.014 (-1.009)	-0.005 (-1.544)	-	0.279 1.905
Germany [91Q3 ~ 02Q4]	0.559 (2.532)	0.151 (2.779)	0.003 (0.121)	0.082 (0.569)	0.028 (2.142)	-0.006 (-0.890)	0.649 (2.351)	0.493 2.147
Korea [91Q1 ~ 02Q4]	1.495 (4.258)	0.071 (1.673)	0.014 (1.076)	0.068 (0.483)	0.034 (1.885)	-0.019 (-2.195)	-	0.304 2.171

(Note) Estimated with OLS by the Cabinet Office.

Dependent variables: changes in CPI (seasonally adjusted) over a previous quarter.

GDP Gap: the IMF estimates are translated into quarterly figures by the Cabinet Office.

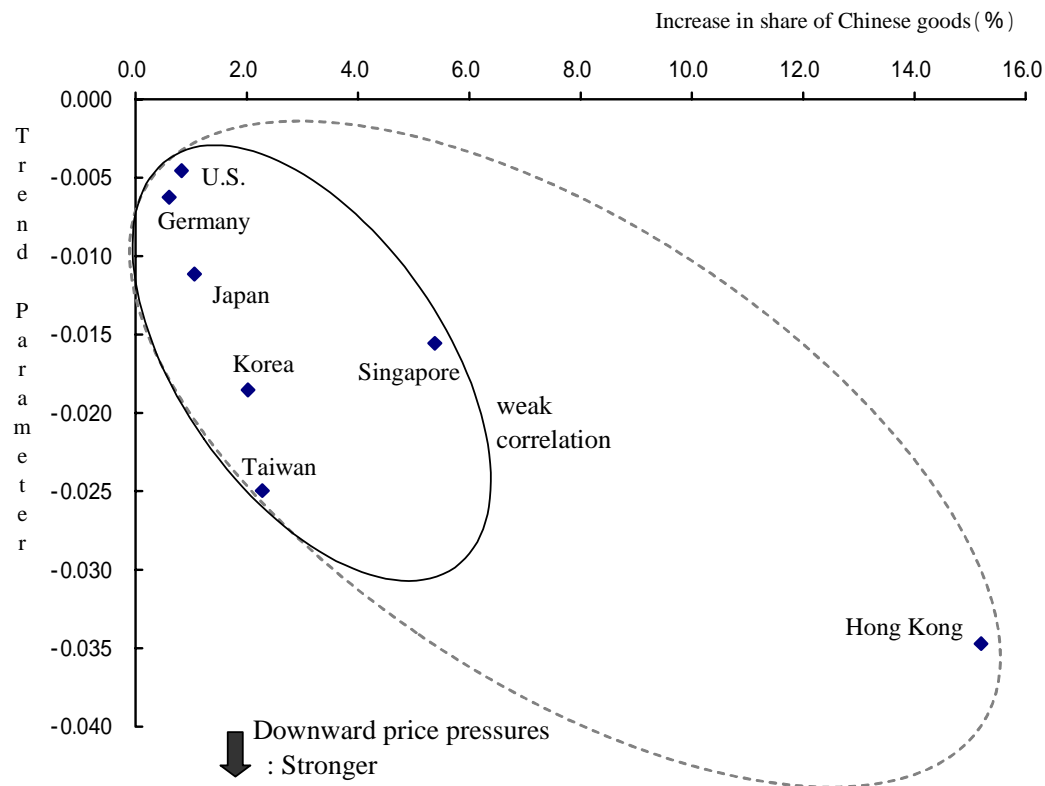
Exchange rate: local currency per dollar. Effective exchange rate for U.S..

Trend: 1 for the starting quarter, added by 1 in each following quarter.

Dummy variables: 1 for Japan 97Q2, Germany 95Q1 and 98Q2, and 0 for others.

The results show the following findings: first, the changes in CPI could be basically explained by GDP gaps and monetary factors; second, there is some weak correlation between the extent of downward pressure on prices during the 1990s and the rise in the share of Chinese goods (Figure 4). In sum, the possibility of a rapid increase of Chinese exports as one factor generating downward pressures on prices cannot be ruled out. However, the order of magnitude attributable to Chinese products could be judged to be small in Japan, considering the extent of actual deflation.

Figure 4 The relation between downward price pressures and share of Chinese goods



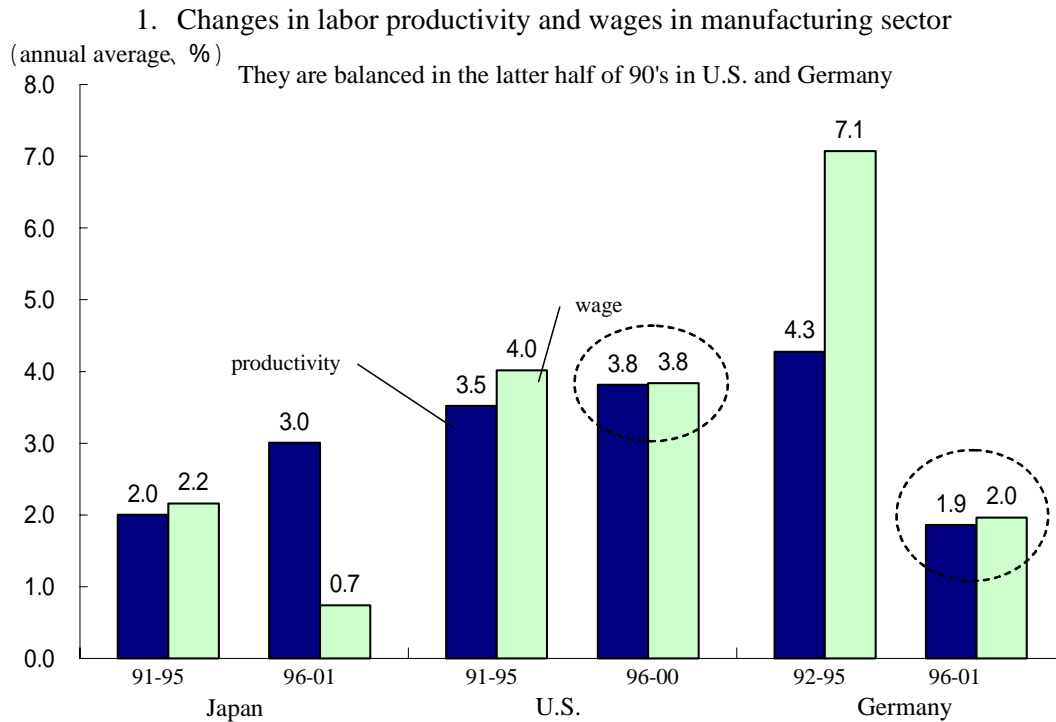
(Note) Trend parameters are from Table 3.

Regarding deflation in Japan, two more facts are revealed concerning wages in comparison with the United States and Germany. In the manufacturing sector, wage increases were lower than productivity growth in Japan in the latter half of the 1990s, while they were balanced in the United States and Germany (Figure 5). Wage moderation might be one factor for price stabilization in terms of lower production costs. In the non-manufacturing sector, wages declined in Japan. The wage drop in the non-manufacturing sector has been weighing down the prices of services. Wages in both the manufacturing and non-manufacturing sectors have been dampening price pressures as profits are squeezed under deflation in Japan.

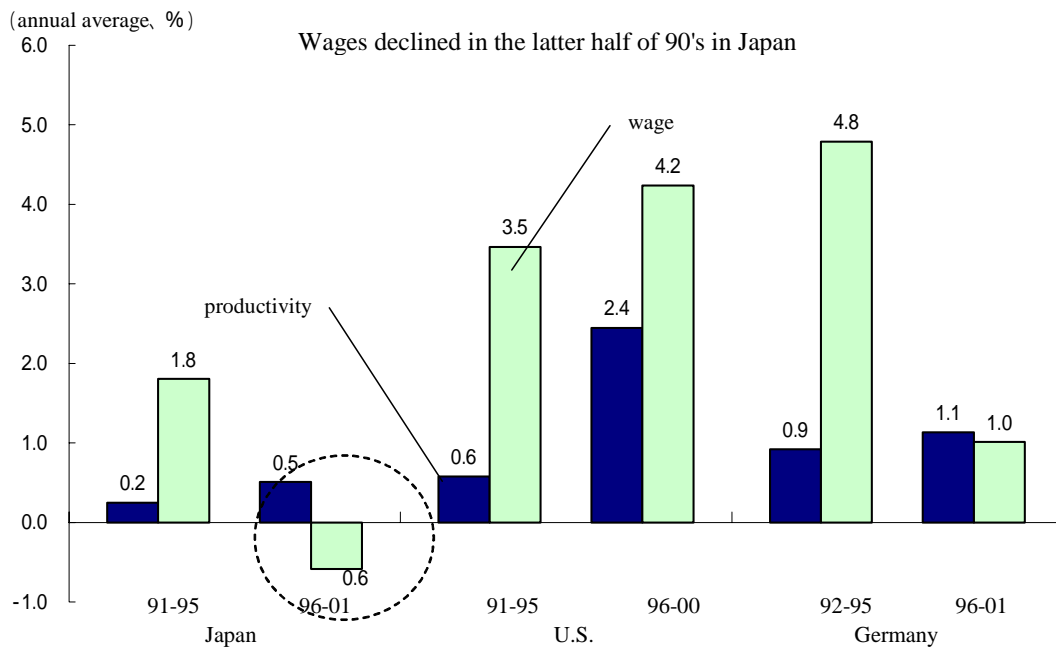
Policy implications for Japan to overcome continuing deflation are: the need for reducing GDP gaps, strengthening monetary policy, and enhancing productivity increases through

structural reforms to realize a matching wage rise.

Figure 5 Labor productivity, wages and prices

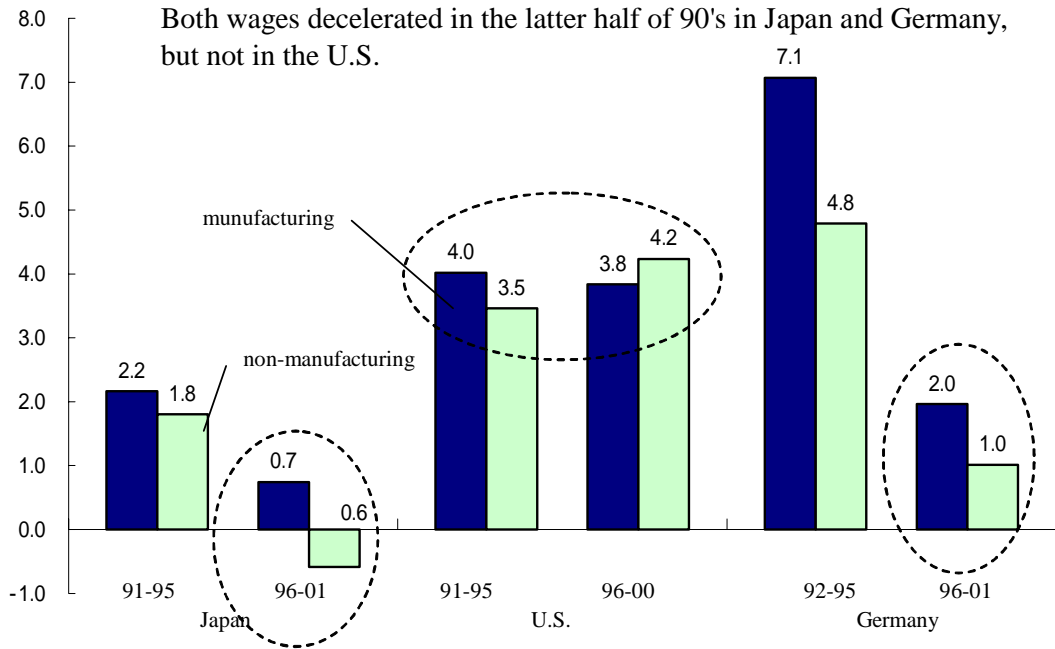


2. Changes in labor productivity and wages in non-manufacturing sector



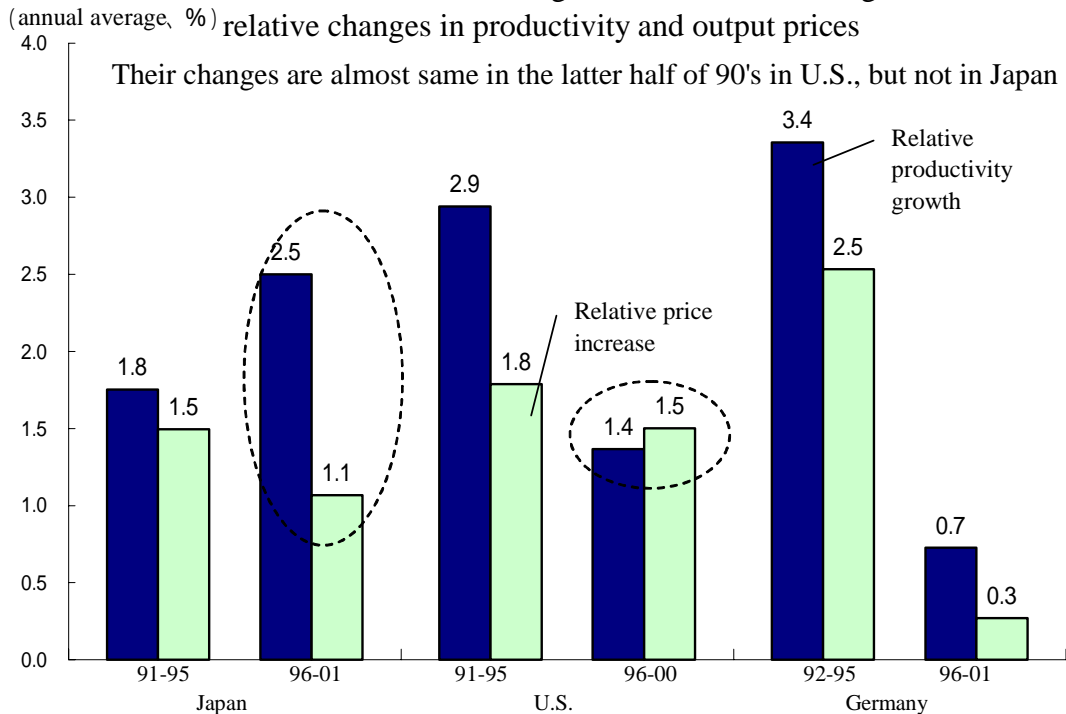
3. Comparison of wages between manufacturing and non-manufacturing sector

(annual average, %)



4. The difference in manufacturing and non-manufacturing sector :

(annual average, %)



(Source) O E C D "National Accounts"etc.

(Note) Relative productivity growth = manufacturing - non-manufacturing

Relative price increase = service price increase - goods price increase

--Industrial Revitalization

The Japanese government has taken bold steps to accelerate corporate restructuring by establishing the Industrial Revitalization Corporation in April 2003. Chapter 2 thus examined the Nordic and Asian experiences of government-led corporate restructuring. Although the legal power of Japan's newly-established Corporation is limited to facilitating the private corporate restructuring process, Nordic and Asian governments, in contrast, used their enforcement powers from time to time, since the stabilization of systemic financial crises was urgently required. Their experiences give us some clues to industrial revitalization. The bottom line is that if the private sector has neither the needed skills nor experience in corporate restructuring, the government should take the leading role to promote it. That way, the non-performing loan problems will be resolved much sooner (Table 6).

Table 6 Financial Crises in Nordic and Asian Countries

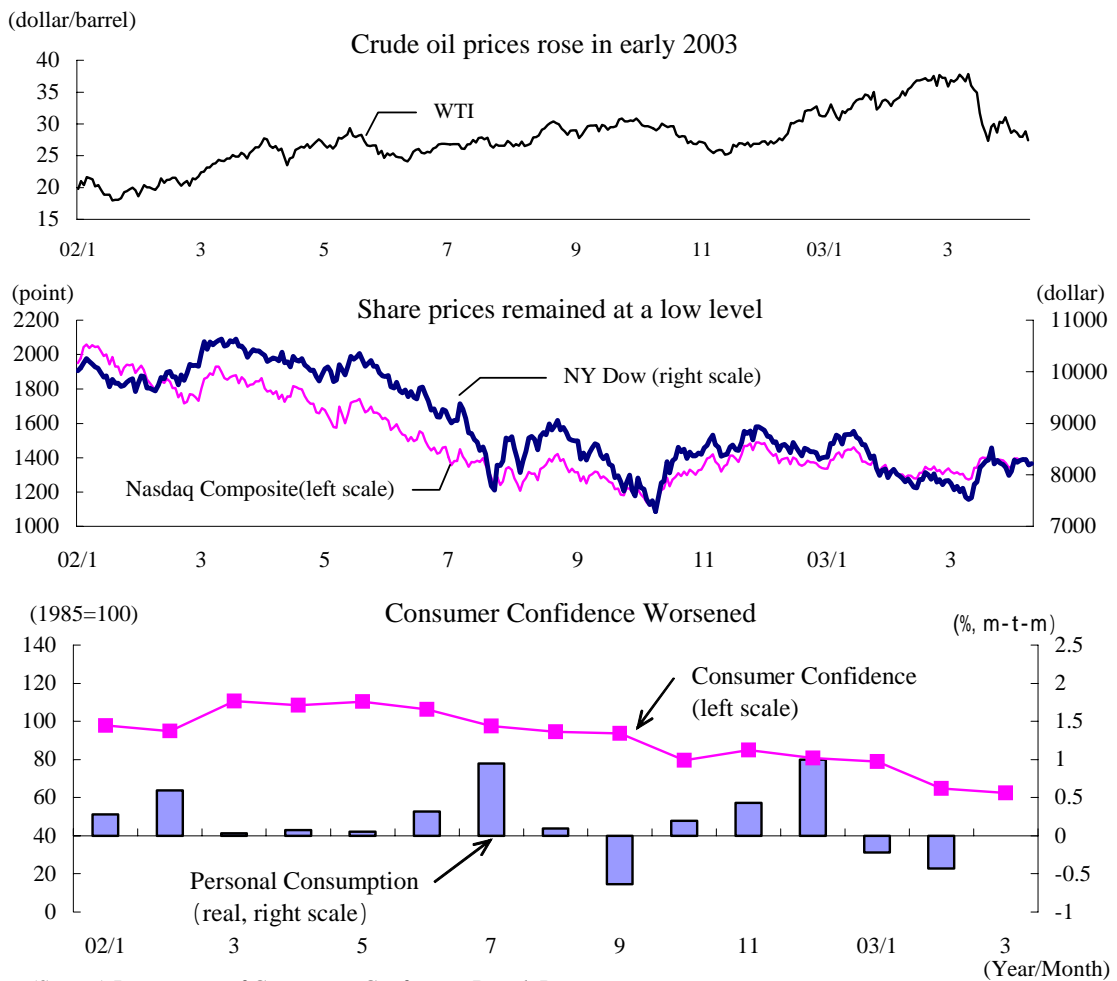
	Crisis period	Crisis classification	Non-performing loans as percent of banking system assets		Fiscal cost (in percent of GDP)	Estimated loss (in percent of GDP)
			peak	present		
Sweden	1991	Systemic	18%	-	4%	6.5% (91 - 92)
Finland	1991 - 94		13%	-	11.2%	23.1% (91 - 96)
Korea	1997 -present		30 ~ 40%	3.1% (March, 2002)	28%	16.5% (97 - 98)
Malaysia	1997 -present		25 ~ 30%	10.8% (March, 2002)	16.4%	22.8% (97 - 99)
Cf. United States	1984 - 91	Nonsystemic	4%	-	3%	-

(Source) Caprio and Klingebiel [2003], Kane and Klingebiel [2002], Honohan and Klingebiel [2000], IMF *World Economic Outlook*, May 1998.

--World Economic Outlook

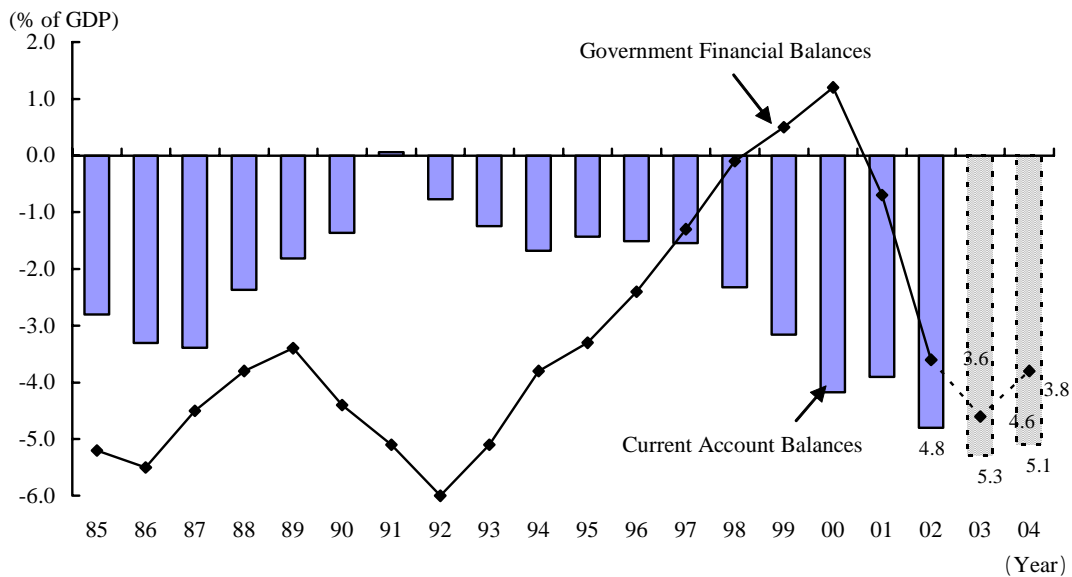
The situation over Iraq became tense in the second half of 2002, causing oil price to rise, equity prices to decline, and consumer sentiment to worsen. These effects, combined with a delay in recovery in the business sector, weakened the momentum of the U.S. economic recovery (Figure 7).

Figure 7: Iraqi Situation Weakened U.S. Economic Growth



When the war in Iraq started, oil prices and equity prices were generally stable. The war did not bring serious damage to the U.S. economy. But the government financial deficits have expanded, partly owing to the supplementary budget for the war. There is a concern that twin deficits (government financial deficits and current account deficits) will harm economic growth in the long run (Figure 8).

Figure 8: Deficits in Government Balance and Current Account in U.S.
Twin Deficits are Expanding



(Source) Department of Commerce, IMF "World Economic Outlook"(2003.4)

Economic recovery in the United States and Europe has weakened since last year; the world economy is thus projected to continue to be weak in the first half of 2003. The main scenario for 2003 is that world economic recovery will pick up in the second half if confidence in major countries steadily improves, and if Asian economic growth continues (Table 9).

Table 9: Economic Outlook by Major Region

real GDP	2001	2002	2003		Forecast as of Oct. 2002
			Forecast	Compared with 6 months ago	
the U.S.	0.3	2.4	2.4	↘	3.0
Asia					
Northeast Asia	4.6	6.1	5.9	↘	6.2
ASEAN	1.6	3.9	3.8	↘	4.4
Europe	1.4	0.9	1.2	↘	2.2
Euro Area	1.4	0.8	1.1	↘	2.2

(Note) 1. Figures are an average of forecasts by private institutions published between February and March 2003.

2. Northeast Asia includes China, South Korea, Taiwan Province of China and Hong Kong.
 ASEAN includes Singapore, Indonesia, Thailand, Malaysia and Philippines.
 Europe consists of Germany, France, Italy and U.K.