June 28, 2013

Naoaki Okabe

Fellow, Meiji Institute for Global Affairs

Short Curriculum Vitae) Naoaki Okabe

Graduated from the School of Political Science and Economics, Waseda University in 1969. Joined the *Nihon Keizai Shimbun* that same year, and after serving in roles such as reporter in the economics section held successive posts as a correspondent in Brussels, head of the New York branch office, executive director of the editorial board, special executive director, and columnist. Has held his current post since 2012. His major works have included *A Leaderless World*, *A Primer to the Japanese Economy*, and *Reciprocity: The Political Dynamics of the Yen and Dollar*.

The Global Economy Is Reeling from the "Exit Strategies" of China and the US

The global economy is being shaken by the "exit strategies" of the two major powers of the United States and China. The global economy was thrown into upheaval, such as from outflows of capital from the markets of newly emerging countries, by virtue of the fact that the US Federal Reserve Board (FRB) has hinted that it will curtail its monetary easing. In conjunction with this, the new administration of Xi Jinping in China has been working to pop bubbles, such as by stamping out the "shadow banking" sector, which has spurred on falling stock prices around the world. Now perhaps the exit strategies of the United States and China are unavoidable options when it comes to righting their own respective economies, but the fact of the matter is that given the interconnectedness of global markets the shift in strategies of these two great powers—which can be seen as them selfishly putting their own country's interests first—serve as roots of instability for the global economy. Japan, which has continued with its "new dimension" of quantitative easing throughout all of this (though it is behind the curve on this), could potentially be saddled with new risks if it errs in its response.

Bernanke's Strategy upon Completing His Term

The statements of Chairman Bernanke of the FRB from June 19 suggesting that the FRB would curtail its monetary easing roiled markets. This is because it had been seen as placing emphasis on preserving its monetary easing so as to not have an impact on global markets, which are already unstable even in the best of times. Almost as if he was shrugging off such observations of the market, at the press conference Chairman Bernanke clearly expressed his intention to curtail the third round of quantitative easing, which has been in place since September 2012, as long as the economy continues to improve. In addition, he also indicated a time frame for the exit by saying that it would be appropriate to stop quantitative easing by the middle of the following year.

Perhaps Bernanke's statements, which could be said to have disregarded the impact this would have on markets, is not unrelated to his completing his term as chairman. Chairman Bernanke, who is approaching the end of his term in office at the end of January 2014, currently has no possibility of being reappointed. Bernanke's eight years as chairman, which reached their peak with the banking crisis caused by the collapse of Lehman Brothers in 2008, could be described as a period where the FRB was forced to make some of its most difficult choices. As the time for completing his term comes into view, it is not unusual that he would indicate an exit from the new dimension of quantitative easing, as this is considered to be the duty of a central bank. Surely he must have listened to the opinions of former Chairman Volcker of the FRB and others. Perhaps the thought flashed through his mind that he should lay out a path for Vice Chairwoman Yellen of the FRB, former Treasury Secretaries Summers and Geithner, and others to throw their hats in the ring as candidates to become the new chairman.

When it becomes clear that employment and other economic indicators are improving, then the new dimension of monetary policy will be normalized. This is par for the course, as this is how monetary policy and other economic policies inherently work. Chairman Bernanke's decision in and of itself could be said to be appropriate. But the grim reality is that doing so will shake the global economy, primarily the economies of newly emerging countries. Backward flows of money from quantitative easing are taking a toll on the economies of newly emerging countries. The reason that demonstrations against the Brazilian government, which is preparing to host the World Cup next year, are spreading is because of mounting discontent over hikes in transportation charges and surging food prices.

The impact from the triple depreciation of stocks, bonds, and money orders has spread to not only the BRICs (Brazil, Russia, India, and China) but to newly emerging countries on the whole. There are also fears over the possibility of the former Asian currency crisis recurring.

The worry is that ever since Chairman Bernanke's statements concerning the curtailment of monetary easing, the long-term interest rates in the United States that had been in a slump have been climbing steeply. Normal increases in long-term interest rates as a result of improving business conditions are natural, but if it is a "bad increase in interest rates" that reflects the divestment of bonds, which is spreading globally, then it presents a problem. These act as a drag on the actual economy through such means as raising the interest rates on mortgages. In a report on financial stability the Bank of England, which is the central bank of the United Kingdom, warned about the possibility that a rise in long-term interest rates could have a negative impact on the financial system.

Risk of Popping a Chinese-style Bubble

As if in agreement with the FRB's moves to curtail monetary easing, China has set to work on popping bubbles. The exit strategies of the United States and China even appear altogether as if they were moves that followed the US-China summit meeting, where the two countries were aiming for a new relationship between major powers.

To be sure, the shadow banking sector that has spread throughout China reflects the negative side to the rapid economic development in China. Shadow banking is an arrangement whereby major Chinese corporations provide financing in place of banks, which are subject to onerous regulations. It includes methods for purchasing "entrusted loans" whereby high interest loans are provided to companies that are referred by banks, as well as “financial products” in which the amounts of credited loans are minimized. These are being used for the real estate development in rural areas that is proceeding at a fever pitch. However, there are fears that their easy use will form dangerous links between major corporations and local governments. This could be described as the Chinese version of the sub-prime mortgage crisis from the United States, which was the original source of the financial crisis.

It is apparent that the administration of Xi Jinping is working to take drastic measures against such easy flows of capital—which could be said to be the unpaid bill from the previous administration, which prioritized development—in an attempt to nip any bubbles in the bud. The People’s Bank of China has given its approval for keeping interest rates at high levels in order to curb the expansion of money passing through the shadow banking sector. This in itself is most likely a justifiable act for preventing bubbles, but as a result the Shanghai Stock Exchange Composite Index (SHCOMP), which is a stock index that is representative of China, hit its lowest prices in four and a half years. But that is not all. This also led to a collapse in stock prices in Asia, including on the Nikkei Stock Average, with the effects spreading worldwide. As was to be expected, in a move to keep the size of the impact from this in check, the People’s Bank of China took the bold step of providing financing to certain banks and partially amended its policy of tight credit.

However, the approach of the administration of Xi Jinping has not been to move towards simple economic stimulus even amidst the slowing of growth. This is a radical departure from the previous administration, which embarked upon proactive economic stimulus in order to sustain the global economy following the collapse of Lehman Brothers and the ensuing crisis. While this was helpful in boosting confidence in China internationally, it is believed that the unpaid dues from this must be enormous.

Of course, the approach of the administration of Xi Jinping, which is attempting to accept the economic slowdown and amend China’s overemphasis on development, is sure to leave some dissatisfied within China. The inland regions, which will continue trying to gain the fruits of this growth in the future, are certain to be seeking a path that emphasizes development. Whether or not the new administration will be able to adhere to this policy turnaround given the slowing of growth will depend on its leadership abilities.

The rapid popping of a bubble, as can be seen in the stamping out of the shadow banking sector, is also a source of risk. The starting point of Japan's lost period is believed to have been the popping of its bubble as a result of rapid monetary tightening and the regulations on real estate financing. This led from the bursting of the bubble to prolonged deflation. Learning from Japan's painful lesson shows that extreme prudence is required when it comes to popping bubbles.

The New Dimension of Monetary Easing Has Arrived Behind the Curve

As the United States and China both selfishly put their own countries first in setting their sites on their exit strategies, Japan has been working towards a new dimension of monetary easing, which is the first arrow of Abenomics. This has truly arrived behind the curve. While Japan has no other option other than to work on this new dimension of monetary easing in order to free itself from deflation, in such cases it must also keep a close eye on the moves of the United States and China. There are enormous risks from the time lag.

The greatest risk is probably from the rise in long-term US interest rates. If Japan overcorrects its strong yen and goes too far with depreciating the yen, this could potentially have repercussions when it comes to securing energy and people's everyday lives. If this ricochets back as a rise in long-term Japanese interest rates it will not only slow down the economy, but could potentially also bring about a chain-reaction of crises for the financial and monetary systems.

Throughout this the growth strategy that is the third arrow of Abenomics will become more and more important. This is a global market strategy that will boost the international competitiveness of companies, lower the effective corporate tax rate in order to attract foreign investment, implement bold regulatory reforms in strategic sectors like agriculture and medical care, and also have Japan join the Trans-Pacific Partnership (TPP) and Regional Comprehensive Economic Partnership (RCEP).

Restoring Japan-China relations in order to provide an opening for holding summit meetings offers the key to its success.

Combined with this, Japan has also demonstrated a clear stance on fiscal reconstruction. Japan is the only major country to regard primary balance as a financial standard. It should adopt the international standards of fiscal balance and accumulative long-term debt as a share of gross domestic product (GDP). If it were to waver in its stance on fiscal reconstruction then the risk of rising long-term interest rates will become a reality.

As the United States and China work on their exit strategies, questions will likely be raised over how on-target Japan is with its third and fourth arrows.