Japan and the EU in the global economy - challenges and opportunities

Conference, 10 October 2013

First panel: Trade and financial linkages between Europe and Japan: new evidence and scope for improvement

Guntram Wolff, Masahiko Yoshii and Sébastien Lechevalier introduced the conference, leaving the floor to the first panel for the discussion.

Takuji Kinkyo

Trade linkages. The fast growth of Asia has been driven to a significant extent by economic integration, which in turn has been led by foreign trade. The high proportion of vertical intra-industry trade in intermediate goods is a notable feature of intra-regional trade in Asia, reflecting the fragmentation of production processes and the expansion of vertically integrated supply chains. However, the demand for final goods is heavily dependent on outside regions such as the EU and the US; this is clear when looking at "trade in value added" statistics rather than at classical trade figures. Within this complex Asian production networks, a region-wide FTA would create an enabling environment for trade in intermediate goods – increasing the welfare gain and reducing the cost associated with multiple rules of origin in bilateral FTAs – and for the extension of supply chains beyond national borders -making the Asian region more attractive to FDI by MNEs. However, these agreements are still fragmented and incomplete, with many FTAs between ASEAN countries, but no agreements with the major economies of China, Korea and Japan. In this context, a Japan-EU FTA can play a catalyst role for promoting a trilateral FTA among Japan, China, and Korea, which is a prerequisite for a region-wide FTA, such as RCEP – a Free Trade Agreement between ASEAN nations and ASEAN's FTA partners. Japan and the EU should aim at reaching a high standard agreement in terms of scope and depth, which would provide a benchmark for RCEP. Japan-EU and Korea-EU FTAs can be the building block for a future trans-regional agreement between Asia and the EU.

Financial linkages. The speaker explained how a well-developed capital market – in contrast with the existing underdeveloped and foreign-relying capital markets – would be indispensable for sustaining development and avoiding the "middle-income trap". One of the key challenges to ASEAN capital markets, which are already individually small, is their limited market liquidity. Greater access to foreign investors and issuers through market integration will increase the liquidity of domestic markets and broaden the range of products and services. In this perspective, the AEC Blueprint 2015 envisages a single market with a free flow of goods, services, investments, and skilled labors, and a freer flow of capital. However, there are large gaps on regulatory capacity and market infrastructure among ASEAN countries, threatening the integration process. Japan and EU can collaborate to take a leading role in coordinating less-advanced countries and to fill the gap in funding resources. In particular, efforts should be made to reach a high standard FTA agreement that provides a benchmark for Asia's regional FTA.

André Sapir

EU and Japan economies. The speaker pointed out that the production structure of the two regions is similar – no access to natural resources, a small share of agriculture industry and heavily relying on manufacturing. However, both the share of domestic manufacturing value added and the share of manufacturing in world value added and exports have decreased significantly in the EU and Japan.

EU and Japan trade relationship. After a rough period from the mid-50s to the early 90s, in which EU and Japan trade relationship has been difficult, Japan is now the sixth trade partner for the EU, which is heavily dependent on Japanese imports of intermediate goods.

Abenomics and its implications for Europe. The economic strategy of Japan's Prime minister ("Abenomics") - involving three "arrows", namely fiscal expansion, monetary easing and growth-enhancing structural reforms – might have significant implications for Europe, in particular the third arrow, which would be a significant boost to growth. The first arrow has already sparked concerns about further yen depreciation, but the speaker explains that, when looking at this trend with a longer time-span, it is clear that the depreciation has just led to return to a pre-euro situation.

Bilateral FTAs among EU, US and Japan*.* The hope of future Japanese accelerated growth are magnified by the prospect of more intense EU-Japan trade relations, due to the launch of a Japan-EU FTA in March 2013. In the meantime, two other FTA negotiations have been launched in July 2013 between Japan-US (TPP) and US-EU (TTIP). However, the speaker reveals he feels puzzled by the current situation, in which a multilateral negotiation would be preferable and with one of the major players - China- being excluded from these trade agreements.

Michael G. Plummer

Main conclusions:

- The EU-Japan FTA is being hashed out in the context of a rapidly changing global and, especially, Asia-Pacific economic context.
- The results and the two presentations underscore the importance of the EU-Asian economic relationship, but barriers to interaction sap trade and FDI potential, which in many areas are on downward trends in terms of shares.
- EU and Asian economic integration programs will no doubt reinforce a "separation" trend due to trade and investment diversion, as well as "policy preferences" trend (e.g., Asian integration with itself, other OECD; EU with its economic enlargement and EPAs).
- EU-Asian forms of FTAs would likely generate relatively large benefits to both sides (the dual: disengagement could lead to T&I diversion but also "preference exclusion").
- According to the speaker, EU-Asian accords should be more inclusive rather to less inclusive, *ceteris paribus,* but India may be a problem that would lead to weak agreements.

Second panel: Housing Bubbles, Government Responses and Economic/Corporate Adjustments: can Europe learn from Japan?

Tomomi Miyazaki

In the mid-80s the Bank of Japan (BoJ) applied loose monetary policy that led to a bubble on the land price in Japan, then, at the beginning of the 90s the BoJ contracted the monetary supply too aggressively along with quantitative restrictions on lending and austerity measures from the fiscal side caused the bubble to burst. Prices fell and a banking crisis surged as many important banks were largely exposed to land loans. Then came the fiscal expansion of the 90s, Miyazaki's studies show evidence of crowding-out effect of the corporate investment as a consequence of this expansionary fiscal policy.

Sébastien Lechevalier

There is a risk of long-term stagnation in Europe similar to the situation where Japan has been for the last two decades. Similar features include: balance-sheet recession, private sector deleveraging, low power of monetary policy (zero lower bound), the need for labour market reforms and an aging population. But there are two major differences; first, troubled European economies do not have enough fiscal space to apply countercyclical fiscal policies, and second, Japan took too long to reform the labour market and resolve its troubled financial institutions. Europe looks much more like Japan in the early 2000s than in the early 90s, there has been some structural progress. The main lesson is that postponing reforms and the consolidation of the financial system can lead to long term stagnation.

Joachim Fels

Similarities and differences between Japan and Europe:

- The 3 Bs, Boom, Bubble and Bust cycle
- The 3 Ds, Deleveraging, Deflation and Debt
- CRIC, Crisis, Reform, Improvement and Complacency.

The main differences are the absence of deflation (on the positive side for Europe), and the lack of capacity for expansionary fiscal policy (on the negative side). Another dissimilarity between Europe and Japan is that the CRIC

cycle has been much faster in Europe, leading towards earlier reforms.
Lessons for Europe: Avoid deflation by all means, clean up the banks as fast as possible, ease monetary policy aggressively and avoid fiscal tightening before the recovery is consolidated.

Third panel: Monetary, fiscal policy and the financial system in Japan and Europe: a comparative perspective

Wataru Takahashi, Professor at Osaka University of Economics and former Director General of the Institute for Monetary and Economic Studies of the Bank of Japan (BOJ), gave a short lecture on **"Japan and the EU in the Global Economy—Challenges and Opportunities".**

He pointed out the difficult situation and the changing role of central banks. While central banks were historically only in charge of price stability, their mandate is threefold nowadays. They have to deal with: (1) price stability, (2) financial stability, and (3) fiscal stability what leads to tradeoffs in decision making. Since the financial crisis, "fiscal dominance" became a major concern as central banks independence might come under attack. At the same time, the use of Unconventional Monetary Policies (UMPs) is less effective for economic recovery. Good communication, such as forward guidance, however, becomes more and more important.

In the case of Japan, W. Takahashi noted that the exit from UMPs in March 2006 came too early and admits that communication with government and markets has been unsuccessful during the easing period. Despite multiple announcements of the CBs policy, it was not understood by markets. He stresses that a clear future path is required for the exit from UMPs. Additionally, Takahashi addressed the credibility loss in independence of the BOJ due to the sudden adoption of an inflation target of 2% in January 2013 and the anonymous approval of the new Governor's policy at the BOJ's Monetary Policy Meeting in April. There is, however, no clear solution to this "institutional crisis" in policymaking and independence of the BOJ. As an independent political institution it is not possible to be "nonpolitical" and an active role by central banks would require fiscal discipline by the government.

The second speaker, **Jens Ulbrich,** Head of Economics Department at Bundesbank emphasized the before mentioned "holy trinity" of mandates and its turning into a trilemma when things go wrong. He was especially concerned about this issue in the context of a monetary union built on a supranational monetary policy and sovereign fiscal and economic policies.

What went wrong in the EMU? Negative feedback from the financial crisis entering in a vicious circle with deterioration of fiscal positions brought together with unsustainable fiscal policies lead governments to a fiscal limit. This happened because there was too much trust into financial supervision on national level. Since only the aggregate level mattered, there was not enough awareness of country specific imbalances. Besides, the disciplining function of capital markets and contagion effects were largely underestimated and finally, there was no crisis resolution framework available to solve the problems.

To break the vicious circle, instruments like the EFSF and the ESM were introduced as well as fiscal consolidation, structural reforms, macro prudential instruments and conventional and unconventional monetary policy. MP was directed at improving the refinancing situation for banks to support credit to the real economy through interest rates and liquidity operations and purchase programs were launched to ensure its better transmission. All in all, MP helped to mitigate the escalations of the crisis and has supported the real economy and the adjustment process in countries hit most hardly in the crisis. It has, however, entered the border area to fiscal policy and leads to the most important challenge: avoid fiscal dominancy to preserve credibility and independence. Additionally, in times of high public debt, fiscal consolidation raises the questions: When to consolidate and how? The judgement to be made is difficult and prevails in an environment of high uncertainty.

According to J. Ulbrich, a successful stabilisation of the economy requires not only fiscal policy safeguarding government solvency and monetary policy to focus on maintaining price stability but also financial stability policy: Macro prudential instruments and financial sector reforms (regulation, banking union) to mitigate the build-up of imbalances and to increase resilience of the economy.

The following discussion with **Zsolt Darvas** (Bruegel) raised several questions. Would more supervisory control of the ECB help? Would it address the issues at hand better by using macro prudential tools? I was stressed that the independence of the central bank is indeed very important – who else if not the CB should be in charge of decision making (Nishimura)? Despite all merit of independence, the role of the ECB is changing; however, this should imply first a change in the mandate (Ulbrich).

Keynote speech by Peter Praet, Member of the Executive Board of the European Central Bank

Peter Praet focused his comments on the policy challenges faced by Japan and EMU, especially regarding the deleveraging process in the euro area. Even though aggregate dynamics in the euro area are different from the case of Japan in the 1990s, some features of the Japanese experience are very similar to our observations in some euro area countries.
He identified the single supervisory mechanism (SSM), including comprehensive assessment and the single resolution mechanism as crucial for better euro area governance, especially because repairing banks' balance sheets and credibility is necessary to a re-establishing of adequate financing of the economy. Furthermore, to curtail possible adverse effects, preventing disorderly deleveraging will remain essential for countries facing high debt.

Deleveraging in the global perspective become more difficult than in the past and it is therefore crucial to balance the consolidation across generations. This process should, however, be complemented with structural changes in order to improve our economies. Such reforms involve easing business creation and reallocation of workers across industries, and streamlining of state-owned enterprises. This is also true for the Japanese economy in regard of the long term recovery of the economy.

The complete comments by Peter Praet are available here

Fourth Panel: Policy panel: What policy lessons to draw?

The moderator Sébastien Lechevalier opened the debate of the forth panel by leaving the floor to Professor **Kiyohiko Nishimura**.

Nishimura said we could draw three main lessons from Abenomics and the Japanese experience in general. He was of the opinion that policy makers should avoid wishful thinking and face the reality, be proactive instead of reactive and communicate effectively.

- Firstly, even data on the aging population phenomenon are often subject to an underestimation initial bias. As a consequence, both population and fertility rate forecasts are based on biased estimation, which limits the prescriptive effectiveness of policy makers on the matter.
- Secondly, evidences arrive too late and are often too inaccurate. As an example, we could think of the GDP data which has been deeply revised through time. In some cases, evidences are so off time that they have made policy makers lose important windows of opportunity.
- Lastly, communication has a crucial role and we should keep in mind that, especially in the Japanese case, excessive pessimism is very important to counterbalance excessive optimism.

He presented three main takeaways:

1. Japan is an example of spectacular success in changing a nation's mood. The core of the miracle was basically in turning the glass from half-empty to half-full. In other words, communication is crucial not only in politics, but - hopefully - also in economics.
2. The Bank of Japan (BoJ) policy change made the policy momentum fade away causing increased financial volatility. The lesson here would be that the BoE must be free of wishful thinking and use a more persuasive communication strategy.
3. Abenomics faded momentum is due to the re-recognition of uncertainty in the future. This, again, calls for lack of wishful thinking and more effective communication.

Nishimura concluded by recognizing how the chances of ultimate success are still quite good, given that the three crucial *dicta* of no wishful thinking, proactivity and effective communication are not only actually followed by policy makers, but also perceived to be followed.

Michael Plummer started his comment stressing the importance of focusing on TFP and Growth, instead of just finance. He drew some lessons from Italy on the subject by noticing that, when the fiscal space is limited and tax pressure is very high, like in the Italian economy, it is the need of structural changes which is paramount. His opinion was that even if we have overcome the crisis, nothing was actually done. In particular, the collective action is hard to do, because of frictions in politics – this being true especially in the Italian "big and clumsy" political machine. In Italy, most of the debt is hold by foreigners, while around 98% of the Japanese debt is held domestically. This, among the others, is evidence that deep structural reforms are necessary in Italy, as in other parts of Europe. However, it important to understand that policies affecting population and gender, like the ones needed in Japan, are somehow easier to implement than the structural reforms needed in Italy. Among the other reasons behind these difficulties, these are certainly the conflicts of interests and the relative laxism of regulation.

Guntram Wolff made three main points:

- Firstly, we should try to sort out the trade-off between doing the restructuring relatively early and the consequently higher burden on taxpayers. Usually bailing out bankers is not the same as bailing out citizens. On the banking side, we can hope the AQR will actually do the trick, provided that the ECB is perceived to be credible enough. In particular, the ECB could assert its reputation by setting fully transparent stress tests and a credible fiscal backstop, which would need to be more solid than what actually needed. He underlined the need of setting clear standards for bank resolution which should be as centralized as possible.
- Secondly, in terms of monetary policy, we certainly need to avoid deflation, which is already present in some parts of the EA. Also, it is important to understand whether and how the ECB could do more in terms of duration risk, credit risk and QE, as it seems there is actually room for improvements.
- Thirdly, on structural policy, the rebalancing story to be not just about demand, but mostly about supply – in the form of liberalizations. At least, this could be the lesson from Germany.

Peter Praet said the ECB did not detect deflation in the EA as a whole or even in the single countries – although Greece has shown negative inflation. Anyway, even in the case of deflation and consequent de-anchoring of expectations, the EA countries have enough margins to play with their balance sheets. For instance, banks in Italy are relatively well provisioned in terms of collateral. The real problem would be that realising those collaterals is probably more difficult than elsewhere.

Spain has improved considerably after the introduction of bail-ins, but also that changing the rules during the crisis is trickier as it changes expectations. On the other hand, communicating an exercise transparently would drive banks to anticipate and start adjusting their behaviours. The real test for the authorities is the ability to credibly impose a recapitalization - like the one of hedge funds that can be envisioned in Greece - more than actually doing it.

Finally, with the price-to-book values that tend to go up, he questioned what it means for supervisors to actually impose a recapitalization. What should be fundamental in the role of a supervisor is not the amount of money in the backstop, but more the very power of imposing the recapitalisation.

Q&A session

A participant from the European Parliament (EP) started his comment recognizing how Nishimura's call for no wishful thinking should be a lesson for the whole EP. Also, he believed the lack of trust in professionals, authorities and institutions to be a major flaw in the system and that it should be corrected with the highest priority. Another important topic brought up was the "British question": there is an increasing pressure about the possibility for the UK to leave the EU. He hoped that the Japanese lessons will shape a more sensible thinking in London.

Nishimura reacted expressing his doubts about the monetary policy being fully dependent on the fiscal one. At least, he thought, the coordination between the two should not.

An invitee from the Bank of Japan highlighted two main differences between Europe and Japan.

- First, Europe is now going through a post-crisis phase in which it has just started repairing its banks' balance sheets. Conversely, Japan is in a more advanced phase as it finished the clean-up in the late 2005. Japan is now mostly facing issues of dynamism and efforts to keep it on the right track.
- Second, the Japanese experience was mainly about dealing with the NPLs. Instead, Europe has been facing two different crises simultaneously: the bank crisis, along with the EU one.

Prof. Nishimura described himself to be not as optimistic on Japan as other commentators, thinking Abenomics was basically just a big promise.

Guntram Wolff made three main points:

- First, Abenomics is not simply luck, as many actual economic policies – like the QQE or Q-squared – have shown;
- Second, it is important to have a unique leader announcing the new policy, notwithstanding the complexity of coordinating 28 different voices;
- Finally, on the "British question", setting the SRM only within the EA borders would not make much sense as the biggest banking institutions are in the UK. The UK has already made clear it will stay out of the SRM, however this might be a strategic mistake.

P. Praet also commented on the involvement of the UK saying that what really matters is not the country joining the SRM, but more the Bank of England following the agreed set of rules.

M. Plummer said that, even if a stronger and more centralized leadership in Europe were to pay off in the long run, the EU still does not have it because it does not really work in that way. If there is a sort of "muddling-through practice" in Europe it is often for good reasons.

Event notes by Francesca Barbiero, Giuseppe Daluiso, Carlos de Sousa and Olga Tschekassin