Janet L Yellen: Japan in the global economy

Speech by Ms Janet L Yellen, Vice Chair of the Board of Governors of the Federal Reserve System, at the Institute of International Finance Annual Membership Meeting, Tokyo, 11 October 2012.

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I greatly appreciate the invitation from the Institute of International Finance to participate in this session on Japan's role in the global economy. Today, I will offer some reflections on factors holding back the recovery in advanced economies, the contribution that emerging Asia can make in boosting global growth, and the challenges facing Japan.

We have seen marked differences in the strength of countries' recoveries from the global financial crisis. Most advanced economies are growing very slowly and operating well short of potential. By historical standards, their performance is even more anemic that we would have expected, given the nature of the previous recession. This shortfall likely reflects the unusually limited scope for fiscal stimulus at present, which very accommodative monetary policies have not been able to fully offset. The recovery from the global recession of emerging market economies, especially in Asia, has been more robust, but even these economies are slowing in the face of weak global demand, and they would benefit from further progress toward a more balanced model of growth led by domestic demand. Finally, until its tragic earthquake and tsunami, Japan was also recovering more rapidly than the other advanced economies. But it, too, faces issues with the longer-run sustainability of its debt as well as other structural challenges that need to be addressed.

The weakness of the recovery in the advanced economies

The global financial crisis resulted in the most severe worldwide recession since the Great Depression. Historically, such crises tend to leave persistent scars on the real economy, and the current weak recovery in the advanced economies appears to be no exception. Economists at the Federal Reserve Board have added to the growing body of research analyzing recessions and their aftermath, focusing specifically on the factors that determine the pace of recovery once the economy has hit bottom.[1] They find that recoveries tend to be faster following deeper recessions, but slower following long recessions. Recoveries from recessions associated with housing busts also tend to be unusually weak.

This research finds that for the advanced economies – especially Europe and the United States – the growth in output has been somewhat weaker than past history would have suggested, even accounting for the depth and duration of the last downturn. Although monetary policy has been highly accommodative, the pace of fiscal consolidation in Europe and the United States has been much greater during this recovery than is typical following severe recessions. Additionally, in Europe, financial strains have been acute, helping to push the region back into recession. In the United States, spillovers from Europe and a still-depressed housing market also help account for our tepid recovery and elevated unemployment. As I will discuss a bit later, Japan has fared somewhat better, but faces significant challenges of its own.

[1] See Greg Howard, Robert Martin, and Beth Anne Wilson (2011), "Are Recoveries from Banking and Financial Crises Really So Different?" International Finance Discussion Papers 1037 (Washington: Board of Governors of the Federal Reserve System, November), http://www.federalreserve.gov/pubs/ifdp/2011/1037/ifdp1037.pdf.

The role of emerging Asia

In contrast to the advanced economies, emerging market economies, particularly in Asia, recovered sharply from the global downturn, in part by using countercyclical fiscal and monetary policies to bolster domestic demand. Based on the research I referred to earlier, the recovery in the Asian economies appears on pace with what we might have expected, given the severity of the previous recession. This swift recovery has not only benefited Asia, but the global economy as well.

Lately, however, the momentum in the emerging Asian economies has weakened, in part as their exports to Europe and the United States have slowed. Exports to China from other countries in the region have also weakened, partly because of the unwinding of China's earlier stimulus programs, but also because China's exports to the advanced economies have slowed, thus lowering its demand for imported parts and components. For the moment, emerging Asia is offsetting weakness in external demand through accommodative monetary and fiscal policies. But ultimately, it would be desirable, both for the region and for the global economy, if emerging Asia were able to rely less on temporary policy stimulus and more on a fundamental rebalancing of growth toward domestic demand. To be sure, progress toward rebalancing has already occurred, as evidenced by the substantial reduction in current account surpluses in the region since the onset of the global crisis. However, some of this adjustment likely reflects cyclical factors, and, moreover, the aggregate current account of emerging Asia remains substantially in surplus.

Greater reliance on domestic demand would not only help shield Asia's economic growth from the weakness in the advanced economies; it would also boost the well-being of its citizens by enabling them to consume a greater share of the output they produce. Moreover, transforming emerging Asia into an independent engine of global growth would put the global economy on a much surer footing, thus helping to achieve the Group of Twenty nations' commitment to strong, sustainable, and balanced growth.

What about Japan?

Finally, I would like to turn to Japan, whose experience combines elements of both its emerging Asian neighbors and of other advanced economies. Like other Asian economies, Japan shares a history of current account surpluses and export-dependent growth. Also like other Asian economies, the Japanese economy bounced back faster from the global financial crisis, at least prior to its tragic earthquake and tsunami, than most advanced economies, and more robustly than in any Japanese recovery since the mid-1970s. Strong exports to the rest of Asia supported this rebound. However, Japan has not been immune to the slowdown in trade affecting the region. Japanese exports have flattened out since about the middle of 2010, contributing to a negative trade balance for the first time since 1980. Like its neighbors, Japan will need to look for alternative engines of growth.

Notwithstanding its similarities to emerging Asia, the Japanese economy faces fiscal and demographic challenges similar to those of other advanced economies in Europe and the United States. Japanese government spending helped propel the economy's bounceback from recession, but it has also added to public debt, which the International Monetary Fund now projects will rise to 237 percent of gross domestic product (GDP) this year, the largest among the major advanced economies.[2] Along with this high debt, aging of the population and slow GDP growth pose important concerns for fiscal sustainability.

[2] See International Monetary Fund (2012), "Taking Stock: A Progress Report on Fiscal Adjustment", World Economic and Financial Surveys, *Fiscal Monitor*, Table 3: General Government Debt, 2008–13, p. 17 (Washington: IMF, October), www.imf.org/external/pubs/ft/fm/2012/02/fmindex.htm.

To date, the savings of Japanese household and firms have been more than enough to finance the government deficit; indeed, interest rates on government debt have fallen to near record lows. Accordingly, Japan, like the United States, has the scope to carry out fiscal consolidation plans that address long-run sustainability issues without endangering near-term growth prospects. Currently, policymakers in both Japan and the United States face the challenge of designing policies that provide a credible commitment to medium-term deficit reduction without disrupting the fragile recovery. But once in place, such policies should help reduce uncertainty and boost household and business confidence.

Japan would also benefit from measures to increase its potential growth, which is generally estimated to have fallen to less than 1 percent and could decline further as population aging progresses. It is widely believed that easing regulations could promote faster productivity growth, particularly in the services sector. Declines in the working-age population also make it desirable to boost labor force participation. Higher employment and faster productivity gains would help to boost economic activity, enhance fiscal sustainability, and restore Japan’s contributions to global economic growth.

Conclusion

Growth in the advanced economies is still hampered by critical challenges and full recovery is likely to take several years. Emerging market economies, particularly in Asia, have performed better, but both they and the global economy more generally would benefit by further rebalancing of their growth toward domestic demand. Japan initially bounced back more quickly than other advanced economies from the global financial crisis, but its growth has slowed recently, and it also faces serious fiscal and structural challenges. By addressing these challenges, Japan can enhance its long-term prospects and continue to play a leading role in Asia and the global economy.