

VIEWPOINT

The Specter of Global Deflation

In October Japan entered its fourth year of deflation. As the month drew to a close, the government announced a package of measures aimed at both accelerating the reform drive and fighting the deflationary pressure resulting from the disposal of banks' piles of bad loans. Meanwhile, the Bank of Japan, which has been keeping up its policy of quantitative monetary relaxation since March 2001, recently announced its plans to buy up stocks held by commercial banks—a move that had generally been considered taboo for a central bank. Both the government and the BOJ have pulled out all the stops in their campaign against deflation, but Japan continues to be stuck in a seemingly endless downward price spiral.

Japan's case may be the most extreme, but the problem of deflation is now an issue for other economies too. For many years the major industrial democracies of the Group of Seven focused their macroeconomic policies largely on the fight against inflation. As a result of their efforts, the average inflation rate for the G7 countries declined from 8.5% in the 1970s to 6.3% in the 1980s and to 2.9% in the 1990s. And now

there seems to be increasing downward pressure on prices on a global scale. If we look at wholesale or producer prices, we find that year-on-year declines are being registered not just in Japan but elsewhere in East Asia, in Germany, and even in the United States.

In June this year the U.S. Federal Reserve Board released a paper titled "Preventing Deflation: Lessons from Japan's Experience in the 1990s" in its International Finance Discussion Papers series. The authors offer the conclusion that when inflation and interest rates have fallen close to zero and the risk of deflation is high, unconventional monetary and fiscal stimulus is required. Quite possibly with this advice in mind, on November 6 (as the possibility of an attack on Iraq raised concerns about the prospects for the U.S. economy) the FRB lowered its benchmark federal funds rate by a full 0.5 percentage point to 1.25%, a cut that exceeded general expectations.

Looking at other economies around the world, we find the most prominent signs of deflation in East Asia. In Taiwan, for example, consumer prices fell for the third straight month in October, registering a year-

on-year decline of 1.6%, while in Hong Kong the decline has continued for a full 47 months, with a 3.7% drop in October. A weakening of prices can be seen even in China, where—despite vigorous demand—the consumer price index for September was down 0.7% from a year before.

The Chinese economy is continuing to grow at a rate of about 8% a year, but even so it is experiencing deflation. And since its currency, the yuan, is effectively pegged to the dollar, falling prices in China are

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exported to the rest of the world. We can accordingly expect to see increasing pressure for revaluation of the yuan in the period ahead. But this poses a dilemma: If the yuan is revalued, the deflationary pressure within China will become even greater. In the current age of progressing globalization in trade and investment, this sort of deflation is

actually a matter of a global supply-demand gap. In the case of the steel industry, for example, the Organization for Economic Development and Cooperation has been considering various measures for eliminating the global surplus of production capacity, but considering how hard it is to adjust production levels even within a single country, achieving inter-

national coordination will be a daunting task indeed.

Some observers are now suggesting that we face the risk of a global depression comparable to that of the 1930s. Clearly the specter of global depression is an issue that we cannot ignore.

■ Akio Okawara, November 15, 2002

REPORT

Report Card on Japanese Agriculture (2)

In our previous issue (October) we reviewed the present state of Japanese agriculture. This time we will look at Japan's agricultural administration and agricultural issues in international relations.

Agricultural administration

The major problem points in today's Japanese agriculture can be summed up as follows: (1) Unlike other major industrialized countries, Japan has failed to halt the decline in its food self-sufficiency ratio in recent decades, and it is now in a very weak position in terms of food security. (2) The share of the working population engaged in agriculture, forestry, and fisheries is higher than in any other major industrialized country; the fact that food self-sufficiency is declining anyway suggests there are fundamental problems with the structure of Japan's agricultural sector. (3) Even more serious than the decline in the agricultural population are such problems as the choice of what to produce, the size and viability of farms, and the rising average age of those farming; these adversely affect both self-sufficiency and the international com-

petitiveness of Japanese agriculture.

The basic law governing Japanese agriculture was revised for the first time in 38 years in 1999. The revised law is titled the Basic Law on Food, Agriculture, and Rural Areas. Unlike the previous law, which was designed for a period of rapid economic growth within the context of the Cold War setup, the new basic law aims to achieve a form of agricultural administration suited to an economically advanced country in the context of globalization and the multilateral rules of the World Trade Organization.

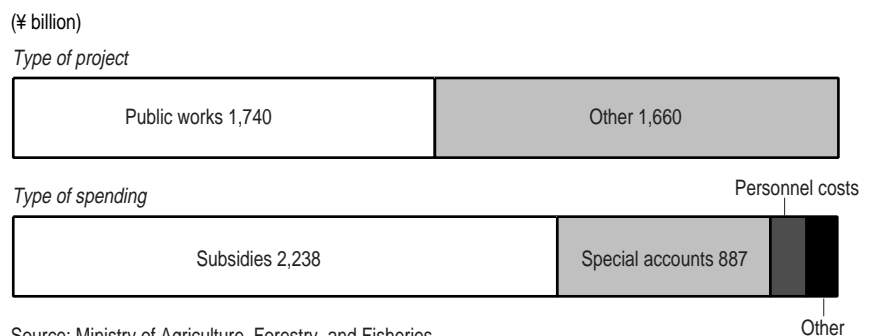
The fundamental concepts of the current law are (1) securing a steady supply of food, (2) fulfilling the multifunctional roles of agriculture, (3) sustaining the development of ag-

riculture, and (4) improving rural areas. Below are its key provisions.

Japan's overall food self-sufficiency ratio is to be raised to 45% by 2010, and as a long-term goal the aim will be to raise it to 50% or higher.

Structural reform is to be achieved through a number of measures. Farming land is to be concentrated in the hands of those who are motivated and capable. Farms are to be made larger so as to improve productivity for crops like rice and wheat. And family farms are to be encouraged to become incorporated for the sake of greater financial solidity, better management, easier entry of new people into farming, and smoother passing on of farms to successors.

Government Spending for Agriculture, Forestry, and Fisheries, FY 2001 (budget)



Source: Ministry of Agriculture, Forestry, and Fisheries.

The government's total appropriations for agriculture, forestry, and fisheries in fiscal 2001 (April 2001 to March 2002) came to ¥3,401 billion, or 3.6% of the general account budget. As shown in the figure, subsidies accounted for ¥2,238 billion, or almost two-thirds of this amount. In addition to the national government, local governments, other government organs, and special public corporations are involved in the provision of subsidies in one form or another for the improvement of agricultural infrastructure and of the environment for farming, as well as to support farmers and their communities. These subsidies have provided a high level of protection for Japan's agricultural sector.

International relations

The Japanese government has focused on the multilateral framework of the WTO as the fundamental element of its approach to global trade liberalization and the formulation of rules governing trade. Until recently, it viewed free trade agreements as only a supplement to the WTO regime. But in a report concerning Japan's FTA strategy that was issued this October, the Ministry of Foreign Affairs stressed the significance and necessity of bilateral agreements, and it noted that market opening and structural reform of the agricultural sector would be an essential part of the process of establishing FTAs.

Early this year the new round of WTO negotiations started, with a target of completion by January 2005. With respect to the talks on agriculture within this round, the basic position of the Japanese government is to press for flexible discipline that will allow various forms of agriculture to coexist in the context of ongoing liberalization. It will draw up its specific offer (itemizing its liberalization commitments) for the ag-

ricultural negotiations in preparation for the fifth ministerial conference of the WTO, to be held in September 2003.

The talks on agriculture have revealed a major split between countries wanting to promote liberalization and those seeking to protect and develop their domestic farming sectors. The participating countries can be classified according to their positions as follows: (1) The members of the so-called Cairns Group, consisting of Canada, Australia, New Zealand, and 15 other food-exporting countries, are pushing for free trade in agriculture. (2) The group calling itself "Friends of Multifunctionality," with some 40 members, including Japan, the European Union, and South Korea, opposes uncontrolled liberalization, stressing the multiple functions of agriculture, such as environmental protection, tourism, and the sustenance of local communities. (3) The developing countries generally want to secure increased exports of their own agricultural products while protecting their domestic agriculture. (4) The United States, while paying massive subsidies to support its own farmers, is pushing for market opening and demanding that the EU and others abolish their subsidy programs.

The Japanese government for many years took a negative or even critical stance toward bilateral FTAs. But in January this year it entered into its first such agreement with Singapore, titled the Japan-Singapore Economic Agreement for a New Age Partnership. Of the 2,777 items on the list of Japan's agricultural imports, 486 are already subject to zero tariff rates; no additional items were made duty-free under this agreement. But it was made to appear as though it applied to agriculture as well through the artificial inclusion of the existing zero-tariff items in the list of items for tariff elimination.

Though the Foreign Ministry has shifted to a positive stance on FTAs, the Agriculture Ministry continues to resist the idea of bilateral agricultural negotiations. But in future FTA negotiations with partners like Mexico and South Korea, unlike in the case of Singapore, it may prove necessary to agree on concessions, including real additions to Japan's list of duty-free agricultural imports, in order to achieve the desired mutual liberalization of market access.

Conclusion

Government administration of agricultural affairs needs to pursue the twin objectives of raising the food self-sufficiency ratio by promoting domestic agriculture and improving its productivity and, at the same time, of moving ahead with trade liberalization, including the adoption of bilateral and multilateral agreements assuring a steady supply of food imports to provide what Japan cannot produce for itself. Through this two-way approach the government must try to build a setup under which food will be available in the necessary amounts at the necessary times—in other words, to guarantee Japan's food security.

The new basic law on agriculture has set the overall direction for agricultural administration, and additional legislation has been enacted for achievement of this law's objectives. So the domestic stage has basically been set. But the shape of Japanese agriculture is likely to come under increasing question in international trade negotiations, both within the WTO and at the bilateral level. The government must strive to conduct agricultural administration befitting an age of globalization.

■ *Takaya Mitamura*
November 15, 2002

INTERNATIONAL AFFAIRS

This section takes a look at major topics on the international scene, offering an outline of developments together with highlights of media commentary and reports from research institutes.

A midterm mandate for Bush

Contrary to the general expectations of a close outcome, the midterm congressional elections held on November 5 in the United States resulted in a clear victory for President George W. Bush's Republican Party, which held on to its majority in the House of Representatives and also recaptured control of the Senate. The Republicans campaigned on a platform of support for the Bush administration's foreign policy and national security agenda, notably its fight against terrorism and hard line toward Iraq. The Democrats attempted to counter with criticisms of the administration's economic policies, but in the end the voters decided to show their support for the Bush team's antiterrorist campaign. Now that the Republicans are on top in both houses of Congress—where the majority party automatically holds the chair of all the committees—the Republican administration can hope for clear sailing not just in matters relating to foreign policy and defense but also in pursuing its domestic agenda.

Commentators have offered a variety of judgments on the outcome of the election. Many suggest that it represented a *de facto* mandate for Bush, whose popularity is high and who campaigned vigorously for Republican candidates. The president's success in raising campaign funds also helped. The Democrats were

unable to present a platform to counter the effect of the mood of patriotic solidarity against terrorism. Observers also suggested that their party leadership was lacking. Below we offer views from two representative commentators on opposite sides of the political fence.

From the conservative side, Charles Krauthammer declared in the *Washington Post* on November 8 that the Democrats lost because they failed to present a clear message. And in his analysis, this is more than a problem of political technique: "The reason Democrats have no message is that they have no ideas." On the domestic front, the welfare policies that they have traditionally supported have faded in importance, and their foreign policy stance of "negotiation and accommodation" is powerless in the face of terrorism. "The Republicans," he assessed, "won on the coattails of George W. Bush," who has the people's respect because he "takes principled positions and takes risks." His popularity, according to Krauthammer, is a product of his leadership.

From the liberal side, meanwhile, in a column appearing in the November 8 *New York Times* Paul Krugman expressed strong regret at the failure of the election to change the direction of the Bush administration's mistaken policies, including fiscal irresponsibility, unilateralism in foreign policy, and neglect of the environment. He also voiced concern that henceforth "anyone who criticizes the administration, even on purely domestic issues, will be accused of lacking patriotism." Krugman urged the Democrats to abandon their post–September 11 reluctance to criticize the Bush administration and to take a clear stand "for the middle

class and against the plutocracy."

The midterm Republican victory is of course no guarantee of reelection for Bush in 2004. From now on he will have a hard time blaming policy failures on Democratic obstruction. Meanwhile, the economy continues to face the risk of a double-dip recession. Dealing with this and other major issues is likely to keep the president on his toes for the next two years.

What next in Iraq?

On November 8 the United Nations Security Council, in a unanimous vote by all 15 members, approved a resolution concerning inspection of Iraq for weapons of mass destruction. Under the new Security Council Resolution 1441, Iraq is required to submit a full report on its programs and facilities involving weapons of mass destruction within 30 days of the date of the resolution; in addition, the resolution calls for the resumption of inspections by the United Nations Monitoring, Verification, and Inspection Commission and by the International Atomic Energy Agency within 45 days and for these bodies to report their findings to the Security Council within 60 days thereafter. Any noncompliance by Iraq is to be reported immediately to the Security Council for appropriate action.

Though the steps that would be involved in using military force against Iraq are not spelled out, the United States and Britain are reserving the option of using force even without further explicit authorization by the Security Council. If they do so, there is a strong chance that it will mean the end of the current regime of President Saddam Hussein.

The biggest question at this point is how Iraq will respond.

The Bush administration meanwhile is pushing ahead with preparations for a military campaign. What sort of scenario does Washington have in mind for Iraq after Hussein? According to an article that appeared in the *Washington Post* on October 27, there is a split within the administration on this issue between “democratic imperialists” and “assertive nationalists.” Those in the former camp “believe the United States should use its overwhelming military, economic and political might to remake the world in its image”—meaning that after Hussein is gone, it should create a democratic government in Iraq and promote the spread of democracy throughout the Middle East. For those in the latter camp, by contrast, the “main concern is to flex American military power

to defeat threats to U.S. security”; these people are deeply skeptical of the notion of reshaping other nations.

Both camps share the desire to oust Saddam Hussein, but as the *Post* noted, “should war come, their differing views could profoundly shape how the war is fought and how the United States goes about winning the peace.” After the war, democratic imperialists will favor an undertaking “similar in scale to the German and Japanese occupations after World War II,” while the assertive nationalists “will want to follow the Afghanistan model and limit U.S. military involvement to immediate security tasks.”

On November 11 the *Wall Street Journal* reported that the Bush administration is considering a plan to station thousands of U.S. troops in Iraq if Hussein is overthrown and “to create an international civil author-

ity, possibly headed by an American, that would administer the country for at least two years before a new Iraqi government takes full control.” But as the article noted, “holding Iraq together following an invasion could be a far more difficult task than toppling Mr. Hussein and his military.”

On November 13 Baghdad informed the United Nations that it would comply with Resolution 1441, but there could still be trouble if, for example, the current regime takes an uncooperative stance toward the inspection process. What will be next for Iraq? This is a question that demands our attention, especially considering the size of its oil reserves, which are second only to Saudi Arabia’s, and the extent of its influence on the rest of the Middle East.

■ *Tadashi Takimoto*
November 14, 2002

INSIDE WASHINGTON

The Republicans’ Historic Victory

In the midterm congressional elections on November 5 President George W. Bush’s Republican Party confounded predictions that while it would hold on to its slim majority in the House of Representatives it would struggle in gubernatorial elections and that the Democratic Party would manage to retain a slight majority in the Senate. Instead the Republicans regained the Senate majority it had lost a year and a half earlier, did better than expected in gubernatorial races, and strengthened its majority in the House.

White House press spokesman Ari Fleischer proclaimed that the president and the party not only had broken the jinx of the president’s party’s perceived disadvantage in midterm elections but had made

history. In the 36 midterm elections held since the Civil War, this was only the third time the president’s party had gained seats in the House, and was the first such victory for the Republicans.

The Bush administration was especially happy about the two Senate seats it picked up—a modest gain, but enough to restore the majority it had lost in May last year. This was the first time the president’s party had regained a Senate majority in first-term midterm elections since the birth of the two-party system of Republicans and Democrats in the 1850s. The achievement is highly significant for President Bush, since the Democrats’ one-seat majority had enabled them to hobble the administration’s legislative agenda.

The biggest factor behind the Re-

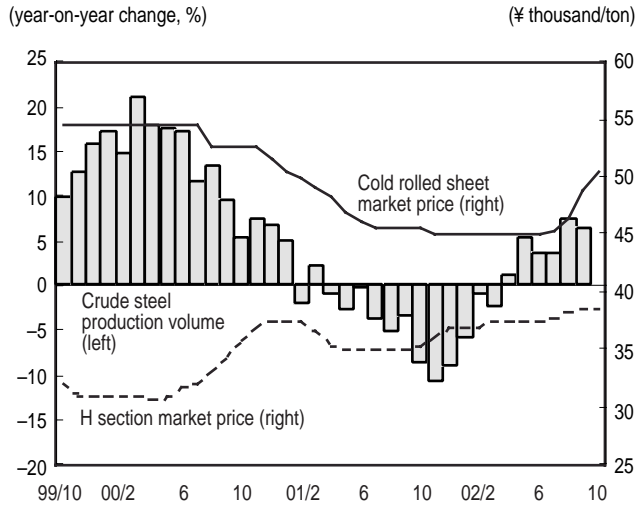
publican triumph was President Bush himself. No other president has campaigned as vigorously. This year he visited 40 of the 50 states—30 of them at least twice. In the last five days of the campaign alone he made a whirlwind tour of 19 states. In some states where the Democrats were favored right down to voting day, Bush’s campaigning is credited with having given Republican candidates the boost needed to get them over the line.

While most pundits had forecast that the president’s high popularity would be a factor in the elections, hardly anyone thought it would be this influential. Even Democrats concede that they lost to his popularity.

■ *Kunio Tsurumi, Washington*
November 11, 2002

JAPANESE INDUSTRY

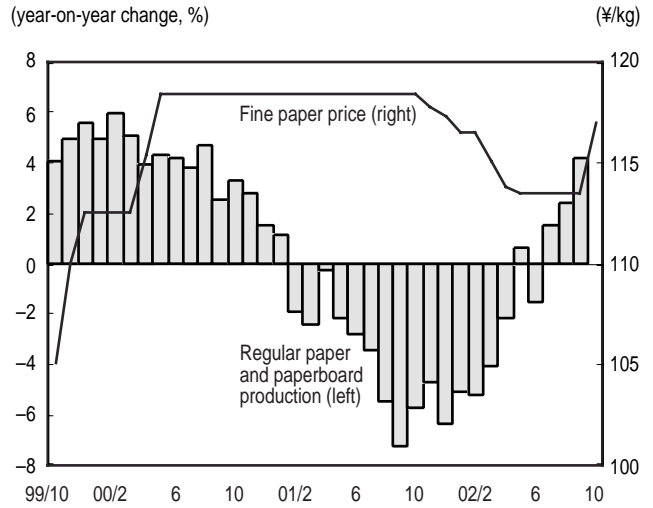
IRON & STEEL



Sources: Economy, Trade, and Industry Statistics Association, etc.

Crude steel production volume was up 6.6% year on year in September, rising for the sixth straight month. Exports have been strong, reaching a record half-year high in the first half of fiscal 2002 (April–September). Domestic automakers are expected to agree to the first price hike in five years, averaging 5%, for steel sheet used in cars.

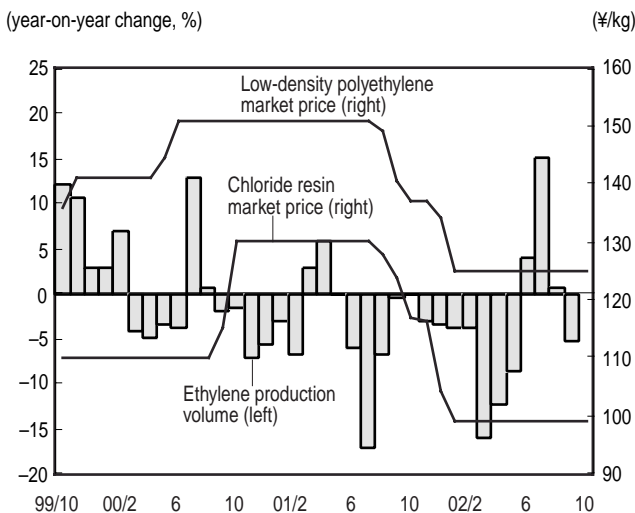
PAPER & PULP



Sources: Research Institute of Economy, Trade, and Industry, etc.

Production of regular paper and paperboard was up 4.2% from a year before in September. Domestic shipments for commercial printing were strong, and paperboard for agricultural use was also up. But exports of used paper hit a 17-month low, only half of the record set in May, as high prices depressed sales, notably to Taiwan and Thailand.

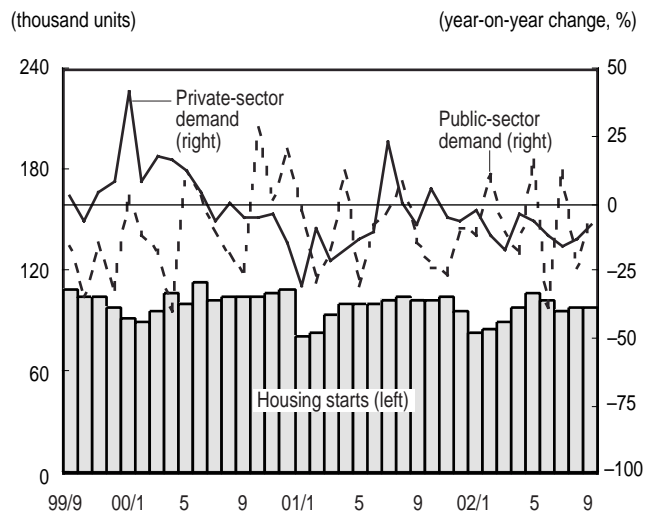
CHEMICALS



Source: Research Institute of Economy, Trade, and Industry.

Ethylene production started falling again in September with a 5.2% year-on-year drop. Chloride resin production was up 6% thanks to strong exports, rising for the fourth month in a row. But as domestic demand lags, the overcapacity-laden PVC industry is hastening to restructure.

CONSTRUCTION



Source: Ministry of Land, Infrastructure, and Transport.

September housing starts fell for the third month in a row, dipping 5.1% year on year. A survey found that condos accounted for 53.7% of new homes bought in the Tokyo area in 2001, a record high for the second straight year.

■ Kanji Ishitsuka and Etsuko Toyama, November 11, 2002

WORLD ECONOMY

Amidst an increasing sense of slowdown in the major industrial economies, some have started to voice fears of deflation. Prices are already falling in Japan, China, and elsewhere in Asia, and now the concern is emerging that the softness of prices in Europe and America will adversely affect businesses there.

Japan

While consumer spending has continued to be relatively strong in **Japan**, deflation and the clouded outlook for the economy have put dampers on capital investment.

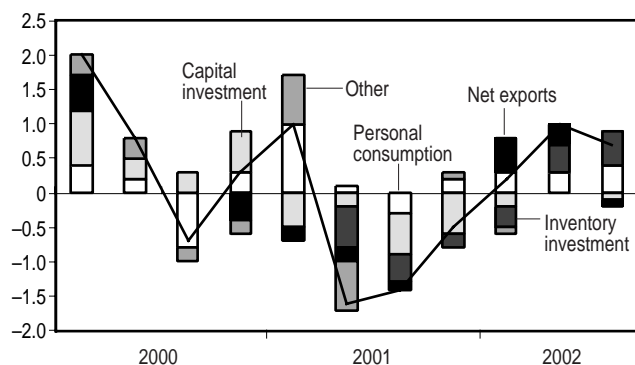
Gross domestic product in July–September was up 0.7% in real terms from the previous quarter, an annualized growth rate of 3.0% (Figure 1). Consumer spending grew faster than in April–June with a rise of 0.8%. But capital investment, which registered positive growth in April–June, returned to the negative range. And external demand (net exports), which had earlier been making a substantial positive contribution to the growth rate, also turned negative in July–September.

The trend of the economy in the near future is likely to depend largely on whether capital investment heads up or down. Machinery orders, which are considered to be a leading indicator for such investment, have been weakening; the forecast for October–December calls for them to decline by 6.5% from the previous quarter.

In its monthly report on the economy for November, the government lowered its assessment of the state of the economy for the first time in a year. Though it judged the recovery to be continuing, it noted that the pace of the upturn was slowing, particularly as seen in the levels of exports and production.

Figure 1. Real GDP Growth, Japan

(%, quarter-on-quarter change, contribution)



Source: Cabinet Office.

Americas

Real GDP in the **United States** grew at an annualized rate of 3.1% over the previous quarter in July–September. Consumer spending was up 4.2%, and capital investment expanded for the first time in two years. But much of the growth was attributable to strong car sales; excluding these, the growth rate was just 1.5%. And most observers are guarded in their outlook for October–December.

Consumer spending and residential investment have been holding up thanks to the firmness of incomes and the lowering of interest rates. But the prospects for the period ahead are highly uncertain given the growing clouds on the horizon, notably the weakening of consumer sentiment due to concerns about deterioration in the employment situation and the stock market decline.

Capital investment has continued its gradual recovery, but some recent economic statistics indicate a loss of forward momentum in production activity. Industrial production has dipped for two months in a row.

Consumer prices have been holding steady overall, but prices of durable goods are on a downtrend, and it is now being suggested that this is liable to crimp business profits. In view of the clouded outlook for the economy, in November the Federal Reserve Board cut the federal funds rate by an unexpectedly large margin of 0.5 percentage point to 1.25%.

In both **Canada** and **Mexico** the central bank lowered its forecast for the economy for this year and next, reflecting both the possibility of a slowdown in the United States and other major economies and uncertainty about the Iraq situation. Following the election in **Brazil**, hopes for the administration of President-elect Lula have begun to emerge, and financial markets have been settling down; meanwhile, exports surged 29% year on year in October.

Europe

Industrial production has bottomed out in Europe, but the recovery appears to lack strength (Figure 2). Declining stock prices and uncertainty about the prospects for the U.S. economy have caused economic sentiment to continue to deteriorate.

In **Germany** the IFO index of economic sentiment has declined for five straight months; feelings of concern about the period to come are evidently growing

stronger. In October the government downgraded its forecast for this year's growth rate from 0.75% to 0.5%.

Consumer spending has remained strong in **France**, where household consumption of manufactured products was up 0.9% from the previous quarter in July–September. But business sentiment has turned down sharply since this summer. The National Institute of Statistics and Economic Studies (INSEE) predicts that for the second half of the year capital investment and exports will be sluggish but consumption will keep the economy growing.

The preliminary figure for July–September real GDP growth in **Britain** was 0.7% over the previous quarter. Both manufacturing and services have remained strong.

Asia

In Asia, export growth has been continuing on the whole, but it shows signs of slowing down in some places, and trends in external demand are a focus of attention.

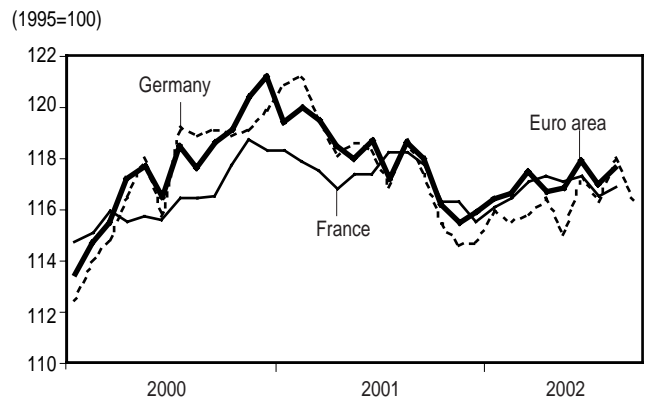
The expansion of production has been sustained in **South Korea**. Exports surged 26% from a year before in October.

Both **Taiwan** and **Hong Kong** are still recording export growth, but domestic demand is weak and prices have been declining. Consumer prices fell 1.6% from a year before in Taiwan in October and 3.7% in Hong Kong in September.

Singapore has also been continuing to enjoy a recovery powered by the expansion of exports, but the momentum of this growth seems to be petering out, with the export figures for August and September more or less unchanged from the previous month. The quarterly growth rate of real GDP turned negative in July–September, but the figure was up 3.7% from a year before, the same year-on-year growth rate as recorded in April–June.

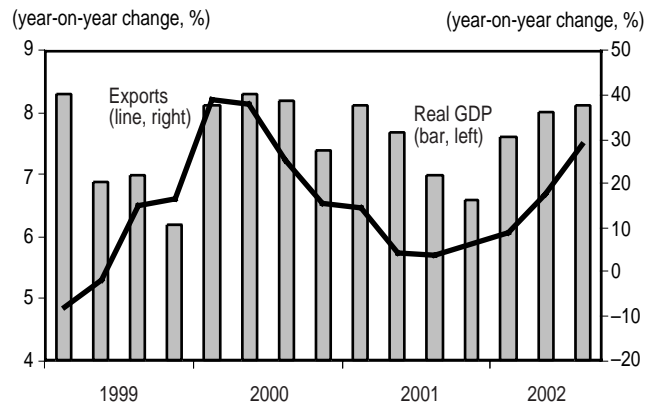
Industrial production in July–September was up 10.4% from a year before in **Thailand**, and it grew by 7.5% in **Malaysia**. Both growth rates were higher than in the previous quarter. In the **Philippines** the statistics

Figure 2. Industrial Production, Euro Area



Sources: National statistics.
Note: Excluding construction industry.

Figure 3. GDP and Export Growth, China



Source: Chinese government.

for industrial production were sharply revised at the end of October; according to the new figures, production has been lagging.

China's growth rate for July–September was 8.1% year on year (Figure 3). In the first nine months of 2002, exports were up 19% from a year before, and inflows of investment from abroad grew by 22%. This growth has been powering the economy as a whole. But despite the strength of demand, prices have been softening; the consumer price index was down 0.7% year on year in September.

■ **Fumio Oi, November 13, 2002**

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