Stimulating conversation

Economist Insights

Somewhat implausibly, Japanese Prime Minister Shinzo Abe used the platform of last week's G7 meeting to declare that the state of the global economy is as bad as it was in 2009, post-Lehman. None of the key economic indicators support that assertion, so why make such a claim? For Prime Minister Abe,the answer to that question probably lies very close to home, but his preferred solution is unlikely to be met with a resounding chorus of approval further afield.

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The G7 looks like a rather anachronistic grouping. Once upon a time it was the group of the seven largest economies. Only five of the seven are still ranked in the top seven. Huge economies like China and India are not members. But to concentrate on the size of the economy is to miss the whole point of the G7. The G7 is a club of like-minded, influential economies. Taken together, the voting power of the G7 in organisations like the IMF, the World Bank, the UN and the WTO is huge. Any deal that the G7 put together between themselves has a good chance of becoming the official policy of any of these organisations.

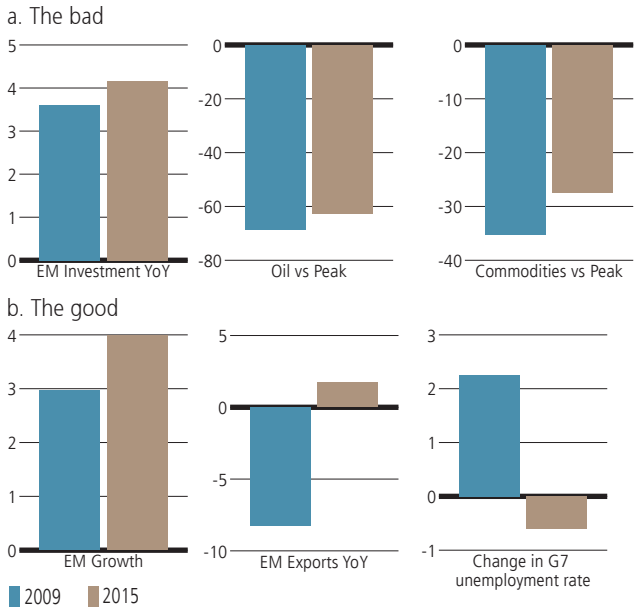
It was Japanese Prime Minister Shinzo Abe's turn to host the G7 meeting last week. He took the opportunity to argue that the current economic situation is as bad as the post-Lehman crisis. He noted that commodity prices had fallen by over 50% and that investment growth in EM is at its slowest pace since 2009 (chart 1a).

The scale of the commodity price movements may be similar, but that does not make them the same. There is a world of difference between a collapse in prices that comes from a negative demand shock (a recession) and one that comes from a positive supply shock (over-supply). Neither are great outcomes for commodity producers, but the positive supply shock is great news for consumers.

More interesting are not the similarities, but the differences. Emerging market growth is higher, export growth may be low but at least is positive, and the unemployment rate in the G7 has been dropping (chart 1b). And these are just a few of the comparisons. Equity markets, core inflation, confidence, you name it – all look markedly better now than they did in 2009.

Chart 1: Not so ugly

Comparisons of 2009 and 2015



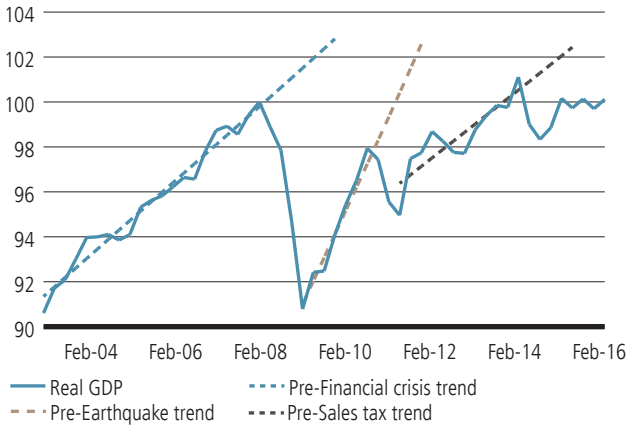
Source: IMF, Thomson Reuters DataStream, UBS Asset Management

So why has Mr Abe suggested such an odd and palpably incorrect comparison? What is his ulterior motive? Quite simply it looks like he wants political cover for more fiscal easing in Japan. Mr Abe had committed to raising the sales tax in March next year (a fiscal tightening) unless there was either an earthquake or an economic crisis. Hence his efforts to get the G7 to agree things are as bad today as in the post-Lehman crisis.

Regardless, deferring the sales tax looks like an obvious solution. Just look at the performance of the Japanese economy over the last decade or so. First the financial crisis hit and knocked real GDP well off its pre-crisis trend (chart 2), just as happened in most other economies. The recovery was quite rapid, but then the Tōhoku earthquake hit, and once again real GDP was thrown off its trajectory (not that the trajectory could have continued at that pace). After the earthquake, the recovery resumed at a slower pace. Then the sales tax hit, and derailed growth once again.

Chart 2: Re-derailed

Japanese real GDP, (pre-crisis peak = 100)



Source: Japanese Cabinet Office, UBS Asset Management

The experience of sales tax increases in other countries would not have given cause for concern beforehand. Consumers tend to bring expenditure on durable goods forward to avoid the higher tax, which boosts growth in the prior quarter and then slows it in the subsequent quarter. Expenditure patterns then normally recover and smooth out. But in Japan they did not. The hit to expenditure appears to be permanent. After that experience, why would you want to do it again?

Some would argue that a sales tax is necessary for fiscal solvency. But the market disagrees: they are so unworried about the Japanese fiscal outlook that they are willing to pay for the privilege of lending the Japanese government money for 10 years. Yet the government has not been keen on using fiscal policy, so they have been relying on monetary policy. But increasingly unusual monetary policy may be upsetting some of Japan's G7 colleagues.

The international knock-on effects of monetary policy tend to be more significant than those of fiscal policy. Exchange rates are linked to relative short-term interest rates; in other words, by expectations of monetary policy in the central banks of each country. Looser monetary policy will push down your exchange rate, which by necessity means a higher exchange rate for other countries. This is why big monetary policy moves often lead to accusations of exchange rate manipulation and currency wars. It is also why in the past central banks have sometimes coordinated their easing.

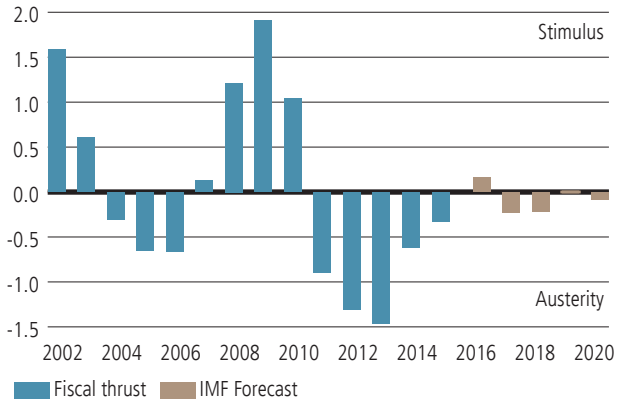
It also explains why there are so many rumours that the G20 (a wider group than the G7 that includes emerging markets) put pressure on Japan to stop cutting interest rates. Given that the marginal negative rate structure the Bank of Japan introduced arguably has little effect on the economy (since it does not affect all rates) but has a lot of impact on the exchange rate, it would not be surprising if other countries may be getting somewhat annoyed.

Fiscal policy has a far less direct effect on others, so should be more acceptable. Extra easing is only really likely to affect the exchange rate if markets expect the central bank to react to the potential inflationary consequences by raising rates. But even if that happens, it pushes the exchange rate up, not down.

While fiscal policy is more palatable from an international perspective, it is not necessarily so palatable from a domestic perspective. In recent years the byword has been austerity: G7 economies have been tightening policy. For economic growth it is not the level of the budget deficit, but rather the change in the budget deficit. This year is forecast to be the first year when this fiscal thrust is positive since 2010 (chart 3). The forecast is for an end to additional austerity but no stimulus. Apparently Mr Abe hopes to change that. For Japan, simply not tightening would be a welcome first step.

Chart 3: Not so tight, please

Change in G7 structural budget deficit ("fiscal thrust") as percentage of potential GDP (positive is stimulus)



Source: IMF World Economic Outlook, UBS Asset Management