

Global Economic System and Domestic Policy

By Mitsuhiro Iyoda

Abstract: Even though the World economy is interlocked, each country has its own culture, and its economic structure and system are not always the same. In the author's opinion, the prolonged Japanese stagnation is caused, on one hand, by the failure of many economists and policy authorities in recognizing the seriousness of stock adjustment and, on the other hand, by Japan's poor adjustment to worldwide globalization. Rawls' difference principle is also advocated, with an emphasis on the importance of the government's strong policy stance.

Key words: global economic system, domestic policy, world economy

There is no common domestic solution toward a global crisis. World economy is interlocked each other, however, each country has its own culture, and its economic structure and system are not always the same. Spending plans were not always effective. In an effort to stimulate the economy after the bubble burst in 1990, the Japanese government introduced nine comprehensive and emergency fiscal packages one after another during the period 1992-2000. The package totals amounted to 122 trillion yen (yen-dollar rate of the period average, 112.9 yen). During the period, economy stagnated and the government mostly financed the budget deficit by issuing bonds.

Various causes have been raised in explaining the prolonged Japanese stagnation, however, in my opinion; the following two might be the most important causes¹. First, many economists and the policy authorities failed to recognize the seriousness of stock adjustment. Many Japanese believed that the real estate prices would always appreciate except perhaps for a short period. But land price continued to decline. As a result, NPLs (nonperforming loans) were increasing until the 2001 fiscal year. The NPL ratio of total credit registered a peak of 8.6 percent at the end of March 2002. Mr. Koizumi took the office in 2001 and his administration tried to resolve the NPL of the banking sector at first.

Second, the other possible explanation for the prolonged stagnation is Japan's poor adjustment to worldwide globalization. Worldwide globalization connected with information technology demanded changes in the Japanese Labor-Management relationship (life time employment and seniority wage system) and in business strategies (restructuring). Those changes had been needed for a long time. In addition, it was fundamentally difficult for the Japanese government to depart from conventional policies to take on socioeconomic reforms (industries and companies with vested interests developed powerful connection with politicians).

Facing the financial crisis or its effect in 2008, many countries adopted aggressive fiscal stimulus measures. Among others, growing country, China, used huge spending plans (primarily for the infrastructure, 4 trillion renminbi), which was effective to boost up the economy. After that, some countries such as Germany and the United Kingdom started to take a strong austerity policy to gain the primary balance (keeping the public finance balance excluding interest payments and debt redemption) in 2010. Other countries more or less continued to adopt spending plans. In any case, the worst-off people should be protected by the safety net. In this respect, the author basically shares Rawls' *difference*

¹ Iyoda, M. (2010). *Postwar Japanese Economy: Lessons of Economic Growth and the Bubble Economy*, New York: Springer. (See chap. 8, sec.3).

*principle*². The principle states that social and economic equalities are arranged so that they are to be the greatest benefit to the least-advantaged members of society. We live in an uncertain world and everyone has a possibility to become worse off. The government should give a strong signal and obtain trust among the nation in which people behave. Otherwise an intended effect of the policy will not be achieved by weak expectations. The strong policy stance of the government is important.

Global economic system based on market capitalism brings economic instability through international trade and the change of exchange rate under the float. The exchange rate is apt to overreact. Therefore, the public finance policy must consider this situation. Domestic conditions (culture, economic structure and system) vary from country to country. The country that has institutional weaknesses is apt to be involved in greater economic fluctuations. As Soros (1998) mentions “One thing is certain: financial markets are inherently unstable; they need supervision and regulation” (p. 194)³. He also recognizes that we do not have a global social system as a countervailing power towards the influence of global economic system. One of the ways to avoid a serious international effect will be to take controls on the exchange rate and capital transactions one way or another. But this will prevent the development of world economy, being not applicable in principle. Readers of the group of 20 at the Seoul Summit (November 2010) issued the statement, expressing their commitment to “enhancing exchange rate flexibility and refraining from competitive devaluation of the exchange rate.” The country should not try to recover the economy by means of devaluation of exchange rate. Beggar-my-neighbor policy⁴ is an example of a fallacy of composition⁵. What we can do for the time being is worldwide cooperation, despite of the difficulty to obtain the cooperation. Various international organizations such as the IMF, WTO, World Bank and OECD have played an important role in the development and the stability of world economy. Further roles are expected, particularly from the IMF. Local monetary cooperation would be also useful such as Chiang-Mai initiative⁶.

FRB chairman, Ben Bernanke recently stressed on a structural defect in the International Monetary System; that is a mixture of two types of countries regarding the exchange rate (fixed or less flexible and float) and capital transactions (free and controlled). As an alternative means, he proposed to introduce “an efficient inspection system of countries with current balance surplus” (November 2010). On the other hand, Chairman Jintao Hu of China suggested reforming the system of key currency, dollar, perhaps introducing a common currency such as SDR (Special Drawing Right) of IMF⁷.

² Rawls, J. (1971; revised 1999). *A Theory of Justice*, Cambridge, MA: The Belknap Press of Harvard University Press. (See chaps. 2 and 5).

³ Soros, G. (1998). *The Crisis of Global Capitalism: Open Society Engendered*. New York: Public Affairs. (See chap. 8).

⁴ Beggar-my-neighbor policy is a course of action that is entered into by a country unilaterally in pursuit of its own self interest in international trade even though this might adversely affect the position of other countries. (quoted from *Collins dictionary of Economics*)

⁵ Fallacy of composition is an error in economic thinking that often arises when it is assumed that what holds true for an individual or part must also hold true for a group or whole. (quoted from *Collins dictionary of Economics*)

⁶ The Chiang-Mai initiative is an agreement by the Ministers of Finance of ASEAN (Association of Southeast Asian Nations), Japan, China, and Korea in May 2005 that calls for the steady cooperation through swap agreements between two countries. (See Iyoda, 2010, p. 138).

⁷ SDR is a monetary asset held by member countries of the IMF as part of their international reserves. The SDR is valued in terms of a weighted basket of leading currencies: US dollar, Euro, UK sterling and Japanese yen.